(13)

No. 93-823-CSX
Status: GRANTED

Title: Nebraska Department of Revenue, Petitioner
v.
John Loewenstein

Docketed:
November 23, 1993

Court: Supreme Court of Nebraska

Counsel for petitioner: Bartel,Leonard Jay

Counsel for respondent: Wittler,Terry R.

Entry	Date	Note	Proceedings and Orders
1	Nov 23 1993	G	Petition for writ of certiorari filed.
2	Dec 29 1993		DISTRIBUTED. January 14, 1994 (Page 4)
3	Jan 10 1994	P	Response requested -- WHR. (Due February 10, 1994)
5	Feb 10 1994		Brief of respondent John Lowenstein in opposition filed.
4	Feb 16 1994		REDISTRIBUTED. March 4, 1994 (Page 1)
6	Feb 24 1994	X	Reply brief of petitioner filed.
7	Mar 7 1994		Petition GRANTED.
			**********
9	Apr 7 1994		Order extending time to file brief of petitioner on the merits until May 3, 1994.
10	May 3 1994		Brief amici curiae of California, et al. filed.
11	May 3 1994	G	Motion of Federal Reserve Bank of New York for leave to file a brief as amicus curiae filed.
12	May 3 1994		Joint appendix filed.
13	May 3 1994		Brief of petitioner filed.
14	May 3 1994	G	Motion of Council of State Governments, et al. for leave to file a brief as amici curiae filed.
16	May 17 1994		Order extending time to file brief of respondent on the merits until June 13, 1994.
17	May 23 1994		Motion of Federal Reserve Bank of New York for leave to file a brief as amicus curiae GRANTED.
18	May 23 1994		Motion of Council of State Governments, et al. for leave to file a brief as amici curiae GRANTED.
19	Jun 13 1994		Brief of respondent John Loewenstein filed.
20	Jun 13 1994		Brief amicus curiae of Investment Company Institute filed.
22	Jun 13 1994	G	Motion of Dreyfus Corporation for leave to file a brief as amicus curiae filed.
23	Jun 27 1994		Motion of Dreyfus Corporation for leave to file a brief as amicus curiae GRANTED.
24	Jul 12 1994		CIRCULATED.
25	Jul 14 1994	X	Reply brief of petitioner filed.
27	Jul 20 1994		SET FOR ARGUMENT TUESDAY, OCTOBER 11, 1994. (1ST CASE).
28	Jul 29 1994		Record filed.
		*	Certified proceedings Supreme Court of Nebraska and Lancaster County District Court.
29	Sep 2 1994		Record filed.
		*	Certified record proceedings District Court of Nebraska for the Third Judicial District.

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93-823

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In The

Supreme Court of the United States

October Term, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE,

Petitioner,

v.

JOHN LOEWENSTEIN,

Respondent.

Petition For A Writ Of Certiorari To The Supreme Court Of Nebraska

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether a state tax imposed on income received by shareholders of mutual funds derived from repurchase agreements involving federal securities violates 31 U.S.C. § 3124 (1988).

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PETITION FOR A WRIT OF CERTIORARI

OPINIONS BELOW

The opinion of the Supreme Court of Nebraska (App. A, ***infra***) is reported as ***Loewenstein v. State,*** 244 Neb. 82, 504 N.W.2d 800 (1993). The opinion of the District Court of Lancaster County, Nebraska (App. B, ***infra***), and the Order amending the district court's opinion (App. C, ***infra***), are not reported.

JURISDICTION

The opinion and judgment of the Supreme Court of Nebraska was entered on August 27, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

31 U.S.C. § 3124 provides, in pertinent part:

> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax. . . .

The Supremacy Clause of the United States Constitution, Article VI, clause 2, provides, in pertinent part:

> This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . , shall be the supreme Law of the Land. . . .

STATEMENT OF THE CASE

The controversy in this case arose as a result of the State of Nebraska's taxation of income received by Respondent John Loewenstein from investments in mutual funds. Loewenstein, a Nebraska resident, owned shares in two mutual funds, the Trust for Short-Term U.S. Government Securities and the Trust for U.S. Treasury

Obligations [the "Trusts"]. The Trusts are no-load, diversified investment companies whose primary objective is to receive current income from ownership of U.S. government obligations. The Trusts invest only in U.S. government obligations and distribute all of their income each year to their shareholders.

The Trusts invest in U.S. government securities either by direct purchase of federal obligations or through "repurchase agreements", commonly called "repos". A standard repurchase agreement consists of a two-part transaction. In step one a party who holds federal obligations and who is seeking cash (the seller-borrower) sells the government obligations to a party who has available cash and who is seeking federal obligations for an investment or some other trading purpose, the buyer-lender (in this case, the Trusts). At the time the contract is formed the buyer-lender agrees to sell back to the seller-borrower, and the seller-borrower agrees to repurchase, the obligations at a higher price than at step one. The resale price includes interest for the period of the sale. The interest paid to the buyer is generally less than that earned by the federal securities; this difference is the seller-borrower's margin of profit. 244 Neb. at 85-86, 504 N.W.2d at 802. The income distributed to Loewenstein by the Trusts flowed both from the Trusts' direct investment in federal securities and from the Trusts' participation in repurchase agreements.

Nebraska imposes a tax on an individual's "federal adjusted gross income", with certain modifications. Neb. Rev. Stat. § 77-2715(2) (1990). One such modification is an adjustment reducing income subject to taxation for "interest or dividends received by the owner of obligations of

the United States . . . but exempt from state income taxes under the laws of the United States; . . . . " Neb. Rev. Stat. § 77-2716(1)(a) (Cum. Supp. 1992). In 1985, the Nebraska Department of Revenue issued a Revenue Ruling determining that income received from repurchase agreements involving federal obligations was subject to Nebraska income tax.[1] Based on the Department's Revenue Ruling,

[1] Revenue Ruling 22-85-1 provides, in part:

> A repurchase agreement is essentially a short-term loan, bearing interest at a specified rate, whereby an owner of government or agency securities obtains funds from a customer, a financial institution, or a broker/dealer. The loan is secured by certain Treasury Bills or other obligations of the federal government owned by the borrower. The terms of the repurchase agreement generally provide for the sale of securities with a prompt repurchase by the owner. The party providing the funds does not receive the actual federal government obligations securing the investment, but does receive a collateral receipt identifying the securities pledged to or sold to the party providing the funds. The risk of ownership and title to the securities does not shift from the operator of a repurchase pool to the investor providing short-term funds. The interest earned on the United States government obligations remains the income of the owner who submitted the securities as collateral for the loan.
>
> The interest income received from repurchase agreements involving obligations of the United States government is income to the investor who provides the funds as a loan secured by government securities. This interest income which is received from repurchase agreements involving obligations of the United States government is subject to the Nebraska individual income tax. It is not to be subtracted from a taxpayer's federal taxable income on the Nebraska return.

Loewenstein was required to pay Nebraska income taxes on the interest income he received from the Trusts attributable to the Trusts' participation in repurchase agreements involving federal securities.

Loewenstein instituted a declaratory judgment action in the District Court of Lancaster County, Nebraska, asking that another Revenue Ruling relating to the taxation of income from the Trusts issued by the Department (Revenue Ruling 22-87-4) be declared invalid as contrary to 31 U.S.C. § 3124 and the Supremacy Clause of the United States Constitution. (App. D, ***infra***). Subsequently, the parties jointly filed a motion to amend the pleadings to include a request for a ruling on the validity of Revenue Ruling 22-85-1. (App. F, ***infra***). The district court found that both rulings violated § 3124 and the Supremacy Clause, and, therefore, declared them void. (App. B and App. C, ***infra***). The State appealed the district court's decision declaring invalid Revenue Ruling 22-85-1.[2]

On appeal, a majority of the Supreme Court of Nebraska affirmed the district court's finding that Revenue Ruling 22-85-1 was invalid. The majority recognized that most courts which have considered the issue have determined that income attributable to repurchase transactions involving federal securities is not exempt from state taxation under § 3124. 244 Neb. at 89-90. 504 N.W.2d at 804-05. It declined, however, to follow this line of

[2] The State did not appeal the district court's decision finding Revenue Ruling 22-87-4 invalid. The substance of the ruling was effectively repealed by the enactment of 1991 Neb. Laws, LB 773, § 13 (***codified at*** Neb. Rev. Stat. § 77-2716 (Cum. Supp. 1992)).

authority, stating "[t]he rationale applied by these courts in determining whether a mutual fund shareholder's income from a repo transaction is exempt under § 3124 is based entirely on whether that party is deemed the true, or direct, owner of the securities." *Id.* at 90, 504 N.W.2d at 805. Stating "[w]e do not believe that direct ownership determines whether income from a repo agreement is exempt under § 3124 . . . ", the majority concluded that "the income received by the appellee in this case, at the very least, is considered indirectly in computation of the tax. In addition, the state tax clearly imposes a burden on the market for federal securities." *Id.* The majority thus found "that the income received by the appellee from repo transactions executed by the trusts involving federal securities is exempt from state taxation under § 3124." *Id.* at 91, 504 N.W.2d at 805.

In a dissenting opinion, Justice Caporale, joined by Justice Grant, expressed disagreement with the majority's opinion, stating:

> [W]hen stripped to their essence, the transactions in question are nothing more than ones in which the plaintiff-appellee, John Loewenstein, participated as a lender in loans secured by various governmental obligations. Therefore, state taxation of the income Loewenstein earned through those participations is not precluded by the Supremacy Clause of the U.S. Constitution through the provisions of 31 U.S.C. § 3124 (1988), and Nebraska Department of Revenue Ruling 22-85-1, issued by the defendant-appellant, State of Nebraska, Department of Revenue, is valid.

Id. at 91, 504 N.W.2d at 805 (Caporale, J., dissenting).

REASONS FOR GRANTING THE WRIT

The decision of the Supreme Court of Nebraska presents a question of importance regarding the power of the states to tax income derived from repurchase agreements involving federal securities. The question of whether state taxation of such income violates 31 U.S.C. § 3124 is one which has been addressed by several state courts, a clear majority of which have held that state taxation of income from repurchase agreements involving federal government obligations is not barred by § 3124. The Nebraska Supreme Court's conclusion that income received by Loewenstein from repurchase transactions involving federal securities is exempt from state taxation under § 3124 is not only in conflict with decisions of several other state courts, but also is contrary to decisions of this Court interpreting the scope of the exemption from state taxation provided to U.S. government obligations under § 3124. The question of whether § 3124 precludes state taxation of income from repurchase agreements involving federal obligations presents an important question of federal law which should be decided by this Court.

I. THERE IS A CONFLICT AMONG STATE COURTS OF LAST RESORT AS TO WHETHER STATE TAXATION OF INCOME FROM REPURCHASE AGREEMENTS INVOLVING U.S. GOVERNMENT OBLIGATIONS VIOLATES 31 U.S.C. § 3124.

The Supreme Court of Nebraska's holding that income received by a shareholder of a mutual fund derived from repurchase agreements involving federal

securities is exempt from state taxation under § 3124 is in conflict with every decision of the highest courts of states which have considered the issue of the taxability of income from repurchase agreements. The highest courts of six states have held that income derived from repurchase agreements is not exempt from state taxation under § 3124.[3] In addition, three other state appellate courts have upheld the state's power to tax such income.[4] The only decision in agreement with the Supreme Court of Nebraska was rendered by an intermediate state appellate court.[5] As a state court of last resort, the Supreme Court of Nebraska stands alone in its view that income from repurchase agreements involving federal obligations is exempt from state taxation under § 3124.

Courts upholding the taxation of income from repurchase agreements have properly recognized that repos, despite their name, are actually secured loans, and that the investor, at least for tax purposes, never owns the federal securities. ***Everett v. Department of Revenue and***

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[3] ***Hammond Lead Products v. Tax Com'rs,*** 575 N.E.2d 998 (Ind. 1991); ***Everett v. Dept. of Revenue and Finance,*** 470 N.W.2d 13 (Iowa 1991); ***Comptroller v. First United Bank,*** 320 Md. 352, 578 A.2d 192 (1990); ***Borg v. Dept. of Revenue,*** 308 Or. 34, 774 P.2d 1099 (1989); ***Massman Const. v. Director of Revenue,*** 765 S.W.2d 592 (Mo. 1989); ***In re Thomas Sawyer Estate,*** 149 Vt. 541, 546 A.2d 784 (1987).

[4] ***Department of Revenue v. Page,*** 541 So. 2d 1270 (Fla. Dist. Ct. App. 1989); ***Capital Preservation v. Revenue Dept.,*** 145 Wis. 2d 841, 429 N.W.2d 551 (Wis. Ct. App. 1988); ***Andras v. Department of Revenue,*** 154 Ill. App. 3d 37, 106 Ill. Dec. 732, 506 N.E.2d 439 (1987), ***cert. denied,*** 485 U.S. 960 (1988).

[5] ***Matz v. Department of Treasury,*** 155 Mich. App. 778, 401 N.W.2d 62 (Mich. Ct. App. 1986).

Taxation, 470 N.W.2d at 15; ***Hammond Lead Products v. Tax Com'rs,*** 575 N.E.2d at 1000; ***Department of Revenue v. Page,*** 541 So. 2d at 1275; ***Andras v. Department of Revenue,*** 154 Ill. App. 3d at ___, 106 Ill. Dec. at ___, 506 N.E.2d at 443-44. The test applied in determining the taxability of income from repurchase agreements should focus on the economic substance of the transaction, not the form or subjective intent of the parties to the agreement. ***Comptroller v. First United Bank,*** 320 Md. at ___, 578 A.2d at 201. ***See Union Planters Nat'l Bank v. United States,*** 426 F.2d 115, 118 (6th Cir.), ***cert. denied,*** 400 U.S. 827 (1970) (holding interest on municipal bonds subject to repurchase agreements not deductible for federal income tax purposes, as "tax consequences should be determined by the economic substance of the transaction, not the labels put on it for property law (or tax avoidance) purposes. . . . "). The distribution of mutual fund income derived from repos is "not interest on the federal obligation but on the repo agreements; . . . ", and is "paid not by the federal government, but by the seller-repurchasers, ... " ***Everett v. Department of Revenue and Finance,*** 470 N.W.2d at 15. As stated by the Iowa Supreme Court:

> The State's tax did not consider, either directly or indirectly, the federal obligations or the interest paid on them in calculating the Everetts' tax. Instead, the tax was based on the interest paid by private seller-repurchasers pursuant to a private sector loan agreement in which federal obligations served as collateral. In such a situation, neither the federal obligations nor the interest thereon is considered in calculating the state income tax. . . . [N]either the

> supremacy clause nor 31 U.S.C. section 3124 prevents the State from taxing the income derived from the repurchase agreements.

Id. (citations omitted).

The decision of the Supreme Court of Nebraska is at odds with numerous decisions of the highest courts of several states, as well as several intermediate state appellate courts. This conflict warrants this Court's review.

II. THE DECISION OF THE NEBRASKA SUPREME COURT THAT 31 U.S.C. § 3124 PRECLUDES STATE TAXATION OF INCOME FROM REPURCHASE AGREEMENTS INVOLVING U.S. GOVERNMENT OBLIGATIONS IS CONTRARY TO DECISIONS OF THIS COURT INTERPRETING § 3124.

31 U.S.C. § 3124 provides, in pertinent part:

> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax. . . .

Section 3124 is a revision and recodification of Rev. Stat. § 3701, as amended, 31 U.S.C. § 724 (1976). Section 3701, as amended, provided, in part:

> [A]ll stocks, bonds, Treasury notes and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both,

> be considered, directly or indirectly, in the computation of the tax, ...

Title 31 of the United States Code was not enacted into positive law until 1982, when it was reformulated "without substantive change." *See* Act of Sept. 13, 1982, Pub. L. No. 97-258, § 4(a), 96 Stat. 877, 1067. Since the recodification did not substantively change the statute, decisions construing § 742 are binding authority in the construction of § 3124.

The Court has "treated [§ 742] as principally a restatement of the constitutional rule [that federal government property is immune from state taxation]." ***Memphis Bank & Trust Co. v. Garner,*** 459 U.S. 392, 397 (1983). "The 1959 addition to § 3701 did not broaden the scope of the exemption required by § 3701 beyond that mandated by the Constitution. . . . " ***First Nat'l Bank of Atlanta v. Bartow Cty. Assrs.,*** 470 U.S. 583, 593 (1985). The exemption for federal obligations provided by § 3701, as amended, has been recognized as "sweeping: with specific exceptions, it 'extends to ***every form*** of taxation that would require that either the obligations or the interest thereon, or both, ***be considered, directly or indirectly, in the computation*** of the tax' (emphasis supplied)." ***American Bank and Trust Co. v. Dallas County,*** 463 U.S. 855, 862 (1983) (***citing Memphis Bank & Trust Co. v. Garner,*** 459 U.S. at 395-96). "Under the plain language of the 1959 amendment . . . the tax is barred regardless of its ***form*** if federal obligations must be considered, either directly or indirectly, in ***computing*** the tax." ***American Bank and Trust Co. v. Dallas County,*** 463 U.S. at 862 (emphasis in original).

American Bank and Trust Co. v. Dallas County involved a Texas property tax on bank shares. The tax "was computed by use of an 'equity capital formula' which involved determining the amount of the bank's capital assets, subtracting from that figure the bank's liabilities and the assessed value of the bank's real estate, and then dividing the result by the number of shares." 463 U.S. at 862-63. The Court determined the tax took "into account, at least indirectly, the federal obligations that constitute[d] a part of the bank's assets." *Id.* at 863. The Court further stated that, "[g]iving the words of amended § 3701 their ordinary meaning, there can be no question that federal obligations were considered in computing the bank shares tax at issue here. In context, the word 'considered' means taking into account, or included in the accounting." *Id.* at 862-63 (footnote omitted). Finding that § 3701 "prohibit[ed] any form of tax that would require consideration of federal obligations in computing the tax", *id.* at 865, the Court held the bank shares tax "violated the plain language of § 3701." *Id.*

The Supreme Court of Nebraska erroneously held that the state's taxation of income received by Loewenstein through distributions resulting from the Trusts participation in repurchase agreements was invalid under this Court's decisions interpreting the scope of the immunity from state taxation accorded under § 3124 and its predecessor because, "at the very least," such income was "considered indirectly in computation of the tax." 244 Neb. at 90, 504 N.W.2d at 805. Neither interest on federal obligations, nor the obligations themselves, were considered in the computation of Nebraska's taxation of Loewenstein's income. In a repurchase transaction, the

federal obligations are not actually owned by the Trusts, but are taken as security for what is, in economic effect, a loan by the Trust to the seller-borrower/repurchaser. The "interest" received by the Trusts is not interest on obligations of the federal government, but, rather, is interest paid by the seller-repurchaser pursuant to the terms of the repurchase agreements. The "interest" received by the Trusts was paid by the seller-repurchasers, not the federal government. Contrary to the Nebraska Supreme Court's conclusion, the state tax imposed on income received by Loewenstein derived from interest received by the Trusts from repurchase transactions did not consider, directly or indirectly, U.S. Government obligations or the interest paid on such obligations. The Nebraska Supreme Court's decision is based on an erroneous application of the standard for determining tax exemption under § 3124, as articulated in *American Bank and Trust Co. v. Dallas County*.

The Nebraska Supreme Court's decision also fails to give proper consideration to the Court's decision in *Rockford Life Ins. Co. v. Illinois Dep't. of Revenue*, 482 U.S. 182 (1987). In *Rockford Life*, the Court addressed whether "Ginnie Maes" were exempt from state taxation under the federal government's constitutional immunity from taxation or under the immunity statute. The Court held that "Ginnie Maes" were not entitled to exemption on either ground, finding that these instruments did not constitute an obligation of the United States, and, therefore, were not immune from state taxation. In holding the instruments did not constitute obligations of the United States under the immunity statute, the Court noted that, while the instruments contained a pledge of the "full

faith and credit of the United States", they were "neither direct nor certain obligations of the United States . . . ," as the issuer bore "the primary obligation to make timely payments – the United States' obligation [was] secondary and contingent." *Id.* at 188.

As to the claim of constitutional immunity, the Court noted the instruments contained no "binding promise by the United States to pay specified sums at specified dates." *Id.* at 189-90 (*quoting Smith v. Davis*, 323 U.S. 111, 115 (1944)). As one of the principal purposes of the intergovernmental tax immunity doctrine is to prevent "States from taxing federal obligations in a manner which has an adverse effect on the United States' borrowing ability . . . ", the Court concluded that "[t]he lack of a fixed and certain obligation by the United States in the Ginnie Mae context ma[de] this concern far too attenuated to support constitutional immunity." *Id.* at 190 (citations and footnote omitted). Moreover, "none of the proceeds of the issuance and sale of the [Ginnie Mae] certificates [were] received by the Federal Government or used to finance any governmental function." *Id.* at 191. The Court concluded by stating as follows:

> A court must proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly established. We do well to remember the concluding words in *Smith*, which although spoken in reference to the statute, are relevant to our role in applying the constitutional doctrine as well:
>
> > 'All of these related statutes are a clear indication of an intent to immunize from state taxation only the interest-bearing obligations of the United States which are needed

> > to secure credit to carry on the necessary functions of government. That intent, which is largely codified in § 3701 [now § 3124], should not be expanded or modified in any degree by the judiciary.'

Id. at 191-92 (citation omitted).

The reasoning in *Rockford Life* applies in the present case. There is no direct and certain obligation of the United States government to the Trusts under the repurchase agreements. The agreements, by their terms, specify that the Trusts will not receive the monies promised by the federal government in the securities which are the subject of the repurchase transaction. In the event of default, the Trusts may sell the obligations at their then-current market value to yet another party and obtain cash from that party. Thus, the federal government does not even stand as a guarantor in relation to the Trusts.

Moreover, as in the *Rockford Life* case, the federal government never receives the proceeds of repurchase transactions. The proceeds flow between private parties, the underlying federal obligations already having been issued at the time the repurchase transaction takes place. This fact undermines the majority's finding that immunity was warranted because "the state tax impose[d] a burden on the market for federal securities." 244 Neb. at 90, 504 N.W.2d at 805. Given the nature of repurchase transactions, it is difficult to conceive how taxation of the income derived from repos and distributed to shareholders of the Trusts imposes an impermissible burden on the borrowing power of the federal government. Absent "a significant effect on the marketability or interest costs of federal securities," . . . , attempts to "find grounds for

derivative tax immunity in every speculative marginal advantage for those who deal with the government and therefore to the government pushes the search for an economic incidence (as distinct from the legal incidence) of a tax too far." ***Borg v. Dept. of Revenue,*** 308 Or. at 40, 774 P.2d at 1102 (***citing*** Tribe, American Constitutional Law 514-18 (2d ed. 1988)).

The Court should grant the writ, as the Nebraska Supreme Court's holding that income from repurchase transactions involving federal securities is entitled to immunity from state taxation is contrary to this Court's decisions applying the constitutional doctrine of intergovernmental tax immunity or the statutory immunity under § 3124.

III. WHETHER 31 U.S.C. § 3124 PRECLUDES STATE TAXATION OF INCOME FROM REPURCHASE AGREEMENTS INVOLVING U.S. GOVERNMENT OBLIGATIONS PRESENTS AN IMPORTANT QUESTION OF FEDERAL LAW WHICH SHOULD BE DECIDED BY THIS COURT.

The Supreme Court of Nebraska's decision that Nebraska's taxation of income distributed to shareholders of mutual funds derived from repurchase agreements involving federal securities is contrary to federal law presents a question of importance necessitating review by this Court. The Court has noted the importance of questions involving the taxing power of state and local governments in relation to the federal government and its activities in granting certiorari. ***Federal Land Bank v. Bd. of Cty. Comm'rs,*** 363 U.S. 146, 149 (1961) (certiorari granted "to determine whether the State had exacted a

tax [on property of Federal Land Bank] forbidden by the Supremacy Clause of the Constitution."); ***Offutt Housing Co. v. County of Sarpy,*** 351 U.S. 253, 256 (1956) (certiorari granted because of "serious questions of state-federal relations [raised] with respect to taxation of private housing developments on Government-owned land. . . . "). The question presented involves an important issue of federal law as to the interpretation and scope of the immunity from state taxation afforded by § 3124.

Moreover, because of the conflict between the Nebraska Supreme Court's opinion and decisions of several other state courts, the tax treatment of income distributed to shareholders of mutual funds derived from repurchase agreements will not be uniform among the states if the Court declines to grant review. In those states which have held the taxation of income from repurchase transactions is not exempt under § 3124, such income will be taxed. In Nebraska, however, such income has been exempted from taxation by the Nebraska Supreme Court's interpretation of § 3124 as mandating exemption of income distributed to mutual fund shareholders from repurchase transactions. The issue of the power of states to tax such income should, as a matter of national policy, be addressed by the Court to ensure uniformity in the tax treatment of income from repurchase agreements by the states. If the Court does not grant review and reverse the Nebraska Supreme Court's erroneous application and interpretation of § 3124, the important goal of assuring uniform application of federal law will not be achieved.

CONCLUSION

The petition for a writ of certiorari to the Supreme Court of Nebraska should be granted.

Respectfully submitted,

State of Nebraska,
Department of Revenue,
Petitioner

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APPENDICES

APPENDIX A

OPINION OF THE SUPREME COURT OF NEBRASKA

Case Title

John Loewenstein, Appellee,

v.

State of Nebraska, Department of Revenue,
Appellant.

Case Caption

Loewenstein v. State

Filed August 27, 1993. No. S-91-255.

Appeal from the District Court for Lancaster County:
Donald E. Endacott, Judge. Affirmed.

Don Stenberg, Attorney General, and David Edward Cygan for appellant.

Terry R. Wittler, of Cline, Williams, Wright, Johnson & Oldfather, for appellee.

LOEWENSTEIN V. STATE

NO. S-91-255 – filed August 27, 1993.

1. Administrative Law: Declaratory Judgments: Appeal and Error. The standard of review on appeal from a declaratory judgment action filed under the Administrative Procedure Act in the district court prior to July 1, 1989, is de novo.

2. Appeal and Error. When the issue in a case is a question of law, an appellate court must reach a conclusion independent from the one made by the trial court.

3. Federal Acts: Intent: Taxation. The congressional intent of 31 U.S.C. § 3124 (1988) is to prevent state taxes which diminish in the *slightest degree* the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit; also, § 3124 exempts from state taxation those federal obligations, and interest thereon, which are directly and *indirectly* considered in computation of the tax and has been interpreted as a "broad" and "sweeping" exemption. It is clear that a state tax on such income would diminish the market value and the investment attractiveness of federal securities, that the tax would impose a burden on the federal government's regulation of the nation's money supply, and that such tax would increase the costs to the federal government in financing the national debt. Therefore, the income received by a mutual fund shareholder from the fund's investment in federal securities using repurchase agreements is exempt from state taxation under § 3124.

Boslaugh, White, Caporale, Shanahan, Fahrnbruch, and Lanphier, JJ., and Grant, J., Retired.

WHITE, J.

The Department of Revenue of the State of Nebraska (Department) appeals the decision of the district court for Lancaster County that Department of Revenue Ruling 22-85-1 violates 31 U.S.C. § 3124 (1988) and the Supremacy Clause of the U.S. Constitution.

The controversy in this case arose out of the State's taxation of income the appellee, John Loewenstein, received from investments in mutual funds. The appellee, a Nebraska resident, owned shares in two mutual funds,

the Trust for Short-Term U.S. Government Securities and the Trust for U.S. Treasury Obligations (trusts). These trusts invested exclusively in U.S. government securities either directly or through repurchase agreements. Pursuant to Revenue Ruling 22-85-1, Loewenstein was required to pay state income taxes on the interest income he received from the repurchase agreements executed by the trusts involving federal securities. Revenue Ruling 22-85-1 provides in part:

> A repurchase agreement is essentially a short-term loan, bearing interest at a specified rate, whereby an owner of government or agency securities obtains funds from a customer, a financial institution, or a broker/dealer. The loan is secured by certain Treasury Bills or other obligations of the federal government owned by the borrower. The terms of the repurchase agreement generally provide for the sale of the securities with a prompt repurchase by the owner. The party providing the funds does not receive the actual federal government obligations securing the investment, but does receive a collateral receipt identifying the securities pledged to or sold to the party providing the funds. The risk of ownership and title to the securities does not shift from the operator of a repurchase pool to the investor providing short-term funds. The interest earned on the United States government obligations remains the income of the owner who submitted the securities as collateral for the loan.

The interest income received from repurchase agreements involving obligations of the United States government is income to the investor who provides the funds as a loan

> secured by government securities. This interest income which is received from repurchase agreements involving obligations of the United States government is subject to the Nebraska individual income tax. It is not to be subtracted from a taxpayer's federal taxable income on the Nebraska return.

In May 1988, Loewenstein filed a declaratory judgment action under the Administrative Procedure Act, in the district court for Lancaster County, asking that Department of Revenue Ruling 22-87-4 be declared invalid pursuant to § 3124 and that the income received by Loewenstein from the trusts be declared exempt from state taxation. See Neb. Rev. Stat. § 84-911 (Reissue 1987). Thereafter, the parties jointly filed a motion to amend the pleadings to include a request for a ruling on the validity of Revenue Ruling 22-85-1. The district court found that both rulings violate § 3124 and the Supremacy Clause of the U.S. Constitution and, therefore, declared them void. The Department appeals the district court's decision, but only with respect to Revenue Ruling 22-85-1.

The Department asserts that the district court erred in determining that the income from repurchase agreements for obligations of the United States constitutes interest or a dividend received by the owner of obligations of the United States and in concluding that Revenue Ruling 22-85-1 is violative of the Supremacy Clause of the U.S. Constitution, § 3124, and Neb. Rev. Stat. § 77-2716(1)(a) (Cum. Supp. 1988). The Department's assignments of error present the following issue: whether § 3124, which provides that federal securities are exempt from state taxation, precludes Nebraska from taxing the income received by

Loewenstein from the trusts' investment in federal securities using repurchase, or repo, agreements. We conclude that this income is exempt from state taxation under § 3124 and accordingly affirm the district court's judgment invalidating Revenue Ruling 22-85-1.

The standard of review on appeal from a declaratory judgment action filed under the Administrative Procedure Act in the district court prior to July 1, 1989, is de novo on the record. See Neb. Rev. Stat. § 84-918(2) (Cum. Supp. 1992). Since the issue in this case is a question of law, we must reach a conclusion independent from the one made by the trial court. *VanDeWalle v. Albion Nat. Bank*, 243 Neb. 496, 500 N.W.2d 566 (1993).

The facts in this case are undisputed. At trial, the parties jointly introduced into evidence two stipulations. The pertinent facts stated in the second stipulation are as follows:

> 1. The Trust[s] . . . are no-load, open-end, diversified investment companies whose primary objective is to receive current income from ownership of U.S. Government securities and obligations, either directly or through the use of repurchase agreements.
>
> 2. The Trusts do not engage in any other business.
>
> 3. The Trusts are qualified as regulated investment companies under Internal Revenue Code Subchapter M and are established under the Investment Company Act of 1940.
>
> . . . .
>
> 5. The Trusts make U.S. Government securities accessible to investors in much

smaller denominations than sold in the marketplace and provide a distribution of the risk through a diversified portfolio of U.S. Government securities.

6. The Trusts invest in short-term securities and obligations of the U.S. Government and its agencies and instrumentalities either directly or through repurchase agreements. The Trusts hold no other securities.

. . . .

10. A standard repurchase agreement ("repo") consists of a two-part transaction.

11. The first part consists of the transfer of specified securities by the seller to the buyer, in exchange for cash.

12. The second part consists of the contemporaneous agreement by the seller to repurchase the securities at the original sale price, plus an agreed upon amount of "interest," paid on a specified future date (the "Maturity Date").

13. Actual delivery is taken of the securities through the Federal Reserve book entry system.

14. There is no separate promissory note executed in connection with the repurchase agreement.

15. The repurchase price of the government securities subject to a repo is typically less than the market value of the securities.

. . . .

18. The repurchase price of the securities is equal to the original sale price, plus the negotiated interest.

19. The interest paid by the seller upon repurchase is less than the interest rate accruing on the purchased securities.

The first stipulation included the depositions of Stewart Brown, a financial analyst and university professor, and Peter Sternlight, executive vice president of the Federal Reserve Bank of New York. These depositions were not conducted by counsel in this case, but, rather, by counsel litigating a case, Page v. Department of Revenue, State of Florida, No. CI 87-2586, in the Circuit Court of the Ninth Judicial Circuit, Orange County, Florida. The parties in Page v. Department of Revenue, State of Florida litigated the same issue that we must address in this case.

Sternlight's testimony stated that repurchase agreements involving federal securities are essential to the efficient functioning of the government securities markets. He stated that repo agreements are an important method for dealers to finance their inventories of federal securities and that primary dealers underwrite 35 to 75 percent of new federal securities. Sternlight testified that an impairment of the repo market would make it less attractive for dealers to underwrite federal securities, thus adding to Treasury interest costs. Sternlight characterized repurchase transactions as the purchase and sale of securities. However, Sternlight admitted on cross-examination that repurchase transactions are very similar to collateralized loans. In addition, he stated that the function of the Federal Reserve to make short-term adjustments in the nation's money supply would be more difficult without repurchase agreements, and that the Federal Reserve would not be authorized by law to use

repurchase agreements if they were characterized as collateralized loans.

Brown's testimony supports Revenue Ruling 22-85-1. Brown testified that the economic substance of a repurchase transaction is a secured loan. Brown also stated that the Federal Reserve could still conduct open-market operations in essentially the same way without repurchase agreements.

The Department also introduced into evidence the affidavit of Donald O. Ellingson, tax law manager in the tax policy division of the Department. In his affidavit, Ellingson provided an analysis of a typical federal securities repurchase transaction between a mutual fund and a bank, the broker-dealer, based on a repo agreement identical to the one utilized by the trusts. Ellingson concluded that the income from the repo transaction was not exempt from state taxation. His conclusion was based on the same rationale applied in Revenue Ruling 22-85-1, that is, the characterization of the transaction as a loan rather than a sale.

Before we discuss the validity of Revenue Ruling 22-85-1 and the state tax authorized therein, it is helpful to briefly describe the state and federal statutory provisions which prohibit state taxation of income earned by Nebraska residents from investments in federal securities. Under Neb. Rev. Stat. § 77-2715(2) (Cum. Supp. 1988), a taxpayer is required to pay state income tax on his or her federal adjusted gross income as modified by § 77-2716. In accordance with § 77-2716(1)(a), a taxpayer may subtract from his or her federal adjusted gross

income all interest or dividend distributions from obligations of the United States which are exempt from state income taxes under the laws of the United States. The federal law which exempts such interest distributions from state taxation is § 3124. This section provides:

> **Exemption from taxation**
>
> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax
>
> . . . .

Section 3124 is a revision and recodification of 31 U.S.C. § 742 (1976). In § 742, the last sentence from the quote above read as follows: "This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, *directly or indirectly*, in the computation of the tax. . . . " (Emphasis supplied.) See Act of Sept. 22, 1959, Pub. L. No. 86-346, § 105(a), 73 Stat. 621, 622. When Congress recodified § 742 as § 3124, the words "directly or indirectly" were omitted as surplus. H.R. Rep. No. 97-651, 97th Cong., 2d Sess. 94, *reprinted in* 1982 U.S. Code Cong. & Ad. News 1895, 1988 (1982). It was the intention of Congress to reformulate § 742 without a substantive change. See Act of Sept. 13, 1982, Pub. L. No. 97-258, § 4(a), 96 Stat. 877, 1067.

Since the recodification did not substantively change the statute, the U.S. Supreme Court's construction of § 742 is also binding authority in the construction of

§ 3124. The Court has " 'treated [§ 742] as principally a restatement of the constitutional rule [that federal government property is immune from state taxation].' " *First National Bank v. Bartow Cty. Tax Assessors*, 470 U.S. 583, 593, 105 S. Ct. 1516, 84 L. Ed. 2d 535 (1985), quoting *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 103 S. Ct. 692, 74 L. Ed. 2d 562 (1983). The Court has interpreted the exemption for federal securities provided in § 742 as a "sweeping" and "broad" exemption. See, *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 103 S. Ct. 3369, 77 L. Ed. 2d 1072 (1983); *Memphis Bank & Trust Co. v. Garner, supra.* This exemption is intended " 'to prevent taxes which diminish in the slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit.' " *Memphis Bank & Trust Co. v. Garner*, 459 U.S. at 396, quoting *Smith v. Davis*, 323 U.S. 111, 65 S. Ct. 157, 89 L. Ed. 107 (1944). However, the Court has also stated that the tax exemption provided by § 742 is not a tax shelter. *First National Bank v. Bartow Cty. Tax Assessors, supra.*

The trusts invest in federal securities in two ways. In the first method, "direct purchase and sale," the trusts purchase federal securities without any restrictions on them, hold them for an indeterminate period of time, then either collect the interest from the federal government on those obligations when they mature or sell them at a later date prior to maturity. When the interest income from such a transaction is passed on to the shareholders of the trusts, it is exempt from state taxation under § 3124. See, *American Bank & Trust Co. v. Dallas County, supra; Memphis Bank & Trust Co. v. Garner, supra; Brown v.*

Franchise Tax Bd., 197 Cal. App. 3d 300, 242 Cal. Rptr. 810 (1987). The second method of investment used by the trusts is to purchase federal securities and simultaneously enter into a repurchase agreement, agreeing to resell the obligations back to the seller at a specified date and price. The dispute in this case involves the state's taxation of the income which the trusts' shareholders receive from these repurchase transactions.

The Department argues that the trusts' repo transactions were really collateralized loans, whereby the trusts did not *own* the federal securities, but, rather, took the U.S. obligations as *security* for a short-term loan to the seller of the securities, a broker-dealer. Therefore, the income earned by the trusts (and subsequent income distributions by the trusts to their shareholders) from a repurchase transaction constituted interest payments on a loan and not interest income from the sale of federal securities. The Department further asserts that this loan was the obligation of the second party (a private party) to the repo agreement, not the obligation of the federal government. The Department concludes that since the income received by the shareholders constituted interest payments from a private party on a loan, a state tax on such income did not involve the consideration of a U.S. obligation, or the interest thereon, in computing the tax. Thus, the subject income is not tax-exempt under § 3124.

The issue in this case is one of first impression for this court. Yet, there are a few jurisdictions which have addressed this issue and have determined that the income from a repo transaction involving federal securities is not exempt from state taxation. See, *Hammond Lead*

Products v. Tax Com'rs, 575 N.E.2d 998 (Ind. 1991); *Department of Revenue v. Page*, 541 So. 2d 1270 (Fla. App. 1989); *Capital Preservation v. Rev. Dept.*, 145 Wis. 2d 841, 429 N.W.2d 551 (Wis. App. 1988); *Andras v. Department of Revenue*, 154 Ill. App. 3d 37, 506 N.E.2d 439 (1987). See, also, *Union Planters Nat. Bank of Memphis v. United States*, 426 F.2d 115 (6th Cir. 1970); *American National Bank of Austin v. United States*, 421 F.2d 442 (5th Cir. 1970) (income from repo transactions involving municipal bonds not exempt from federal taxation). These courts apply a rationale similar to that proposed by the Department. That is, in a repo transaction, the seller-repurchaser (i.e., the broker-dealer) is the party who has the rights and risks associated with ownership of the securities, and as the true owner of the securities, the seller-repurchaser is the only party in the transaction who can claim the tax exemption provided by § 3124. *Hammond Lead Products v. Tax Com'rs, supra; Department of Revenue v. Page, supra; Capital Preservation v. Rev. Dept., supra; Andras v. Department of Revenue, supra.* The rationale applied by these courts in determining whether a mutual fund shareholder's income from a repo transaction is exempt under § 3124 is based entirely on whether that party is deemed the true, or direct, owner of the securities.

We do not believe that direct ownership determines whether income from a repo agreement is exempt under § 3124. The U.S. Supreme Court stated that the long-established congressional intent of § 3124 is to prevent state taxes which diminish in the *slightest degree* the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit. See *Smith v. Davis, supra.* Also, because § 742

was recodified without substantive change, § 3124 still exempts from state taxation those federal obligations, and interest thereon, which are directly and *indirectly* considered in computation of the tax. Furthermore, the Court has interpreted this exemption as "broad" and "sweeping." *See, American Bank & Trust Co. v. Dallas County, supra; Memphis Bank & Trust Co. v. Garner, supra.* Thus, the income received by the appellee in this case, at the very least, is considered indirectly in computation of the tax. In addition, the state tax clearly imposes a burden on the market for federal securities. A review of the expert testimony of Sternlight makes it clear that a state tax on such income would diminish the market value and the investment attractiveness of federal securities, that the tax would impose a burden on the federal government's regulation of the nation's money supply, and that such tax would increase the costs to the federal government in financing the national debt.

We conclude that the rationale and decision in Revenue Ruling 22-85-1 are invalid and that the income received by the appellee from repo transactions executed by the trusts involving federal securities is exempt from state taxation under § 3124. We thus affirm the district court's judgment with respect to Revenue Ruling 22-85-1.

AFFIRMED.

HASTINGS, C.J., not participating.

CAPORALE, J., dissenting.

I dissent; for when stripped to their essence, the transactions in question are nothing more than ones in which the plaintiff-appellee, John Loewenstein, participated as a lender in loans secured by various governmental obligations. Therefore, state taxation of the income Loewenstein earned through those participations is not precluded by the Supremacy Clause of the U.S. Constitution through the provisions of 31 U.S.C. § 3124 (1988), and Nebraska Department of Revenue Ruling 22-85-1, issued by the defendant-appellant, State of Nebraska, Department of Revenue, is valid.

Loewenstein is an investor in funds operated by Massachusetts Business Trusts, a regulated investment company as defined in the Internal Revenue Code, I.R.C. § 851(a) (1988), which funds are commonly known as mutual funds. Under the "General Repurchase Agreement" which controls the transactions in question, a seller of governmental securities to the trusts is obligated to repurchase them by a fixed date, and the trusts are obligated to resell them at a fixed price. In exchange, the trusts receive a fixed rate of return which bears no relationship either to the value of the securities which make up the trusts' funds or to the income the securities produce for the seller, or more accurately, the seller-repurchaser. In short, the seller-repurchaser bears the entire market risk. Moreover, until the repurchase date, the seller-repurchaser has the right to substitute one governmental security for another. Further, the seller-repurchaser and the trusts each have remedies against the other in the event of a default in the respective obligations of either.

Nine of the 10 other appellate courts which have considered this issue have held that under such circumstances, the income to the investors is subject to state taxation: *Hammond Lead Products v. Tax Com'rs*, 575 N.E.2d 998 (Ind. 1991); *Everett v. Dept. of Revenue and Finance*, 470 N.W.2d 13 (Iowa 1991); *Comptroller v. First United Bank*, 320 Md. 352, 578 A.2d 192 (1990); *Borg v. Dept. of Rev.*, 308 Or. 34, 774 P.2d 1099 (1989); *Department of Revenue v. Page*, 541 So. 2d 1270 (Fla. App. 1989); *Massman Const. v. Director of Revenue*, 765 S.W.2d 592 (Mo. 1989); *Capital Preservation v. Rev. Dept.*, 145 Wis. 2d 841, 429 N.W.2d 551 (Wis. App. 1988); *In re Sawyer Estate*, 149 Vt. 541, 546 A.2d 784 (1987); *Andras v. Department of Revenue*, 154 Ill. App. 3d 37, 506 N.E.2d 439 (1987), *cert. denied* 485 U.S. 960, 108 S. Ct. 1223, 99 L. Ed. 2d 424 (1988). The only decision other than that of the majority holding to the contrary is that of an intermediate court of appeals in *Matz v Dep't of Treasury*, 155 Mich. App. 778, 401 N.W.2d 62 (1986). However, the *Matz* court was construing a state statute defining ownership.

While the fact that nine other courts have reached a contrary result to that reached by the majority is not, in and of itself, particularly persuasive, the reasoning illustrated by *Andras v. Department of Revenue*, 154 Ill. App. 3d at 43-44, 506 N.E.2d at 443-44, is:

> In reviewing similar transactions involving municipal bonds, Federal courts have consistently held that the Federal income tax exemption provided for income received from State or municipal obligations (26 U.S.C. sec 103(a) (1982)) is available only to the taxpayer who actually owns the securities – *i.e.*, the taxpayer who has the right to dispose of them and who

bears the risk of a profit or loss. (See *American National Bank v. United States* (5th Cir. 1970), 421 F.2d 442, 451 (and cases cited therein).) Plaintiffs have cited no authority holding that section 742 requires immunizing from State taxation the income of anyone other than the owner of Federal government securities, nor have we found any authority supporting plaintiffs' position.

While we recognize that section 742 is a constitutionally mandated immunization from taxation (see, *e.g., Memphis Bank & Trust Co. v. Garner* (1983), 459 U.S. 392, 397, 74 L. Ed. 2d 562, 567, 103 S. Ct. 692, 695-96) rather than a legislative exemption from a particular tax, the scope of the immunity it affords is not unlimited. In *First National Bank v. Bartow County Board of Tax Assessors* (1985), 470 U.S. 583, 84 L. Ed. 2d 535, 105 S. Ct. 1516, the Supreme Court held that section 742 did not require a State to permit a bank to deduct the full value of its government securities from its gross assets. The court recognized that, because the bank may have incurred liabilities, the interest on which was also deductible, to acquire the securities, the statute was satisfied by the State's allowing only a *pro rata* deduction from the bank's net worth for the securities. The court concluded that the bank should not be allowed to use Federal obligations to shelter otherwise taxable assets. (470 U.S. 583, 593, 84 L. Ed. 2d 535, 545, 105 S. Ct. 1516, 1523-24.) If the Trust is not the true owner of these securities, but is merely loaning the sellers the securities' purchase price and thereby earning otherwise taxable interest income, we conclude that it may not shelter that income from State taxation by allowing the borrowers to

secure the loans with tax-exempt Federal securities.

In determining whether or not a repurchase transaction is actually a loan, Federal courts consider the entire transaction and look to the following specific factors, which, if present, tend to indicate that the transaction is a loan: (1) whether the seller could require the purchaser to resell the securities; (2) whether the purchaser could require the seller to repurchase them; (3) whether the agreement provides either party a specific remedy in the event that the other defaults; (4) whether the seller agreed to pay interest at a stipulated rate between the sale and resale; and (5) whether the amount advanced does not necessarily equal the fair market value of the securities sold. (See *Citizens National Bank v. United States* (Ct. Cl. 1977), 551 F.2d 832, 842.) Other indications of a loan are: (6) whether the identical securities are bought and sold, and (7) whether the purchaser may sell the securities for the seller's account in the event of a default. See I.R.S. Rev. Rul. 74-27, 1974-1 C.B. 24. See also I.R.S. Rev. Rul. 82-144, 1982-2 C.B. 34 (transaction held to be purchase where the purchaser could sell the securities at will); I.R.S. Rev. Rul. 77-59, 1977-1 C.B. 196 (transaction was found to be loan only and the purchaser's assets were found not to be the securities themselves, but the seller's obligation to repay the funds loaned).

Loewenstein argues that repurchase agreements are essential in order to allow the Federal Reserve to adjust the nation's money supply and points to 12 C.F.R. § 32.103(a) (1993), which provides that U.S. Treasury notes subject to a repurchase agreement do not constitute

a loan or the extension of credit. However, as noted in *Hammond Lead Products v. Tax Com'rs, supra,* that regulation relates to commercial banks and the general scheme of lending limits; it has no bearing on the Internal Revenue Code or the judicial interpretation of repurchase agreements.

Loewenstein also argues that repurchase agreements are necessary to increase the liquidity of mutual funds dealing in government obligations in order to satisfy those investors who wish to avoid inflexible terms in their investments. But government securities are, in and of themselves, very liquid; they can be sold readily, albeit with some short-term market risk. Also, a mutual fund could achieve even greater liquidity by borrowing against the government securities it holds. And a fund could also enhance its liquidity by diversifying the maturity dates of the government securities it acquires. The point is that there are other means to achieve liquidity without the use of repurchase agreements, which take exposure to market risks and other incidents of ownership away from the investor and give them to the seller-repurchaser.

As stated in *Everett v. Dept. of Revenue and Finance,* 470 N.W.2d 13, 15 (Iowa 1991):

> The State's tax did not consider, either directly or indirectly, the federal obligations or the interest paid on them in calculating the Everetts' tax. Instead, the tax was based on the interest paid by private seller-repurchasers pursuant to a private sector loan agreement in which federal obligations served as collateral. In such a situation, neither the federal obligations nor the interest thereon is considered in calculating the state income tax. *Borg,* 308 Or. at 38-39, 774 P.2d at 1102; *In re Thomas Sawyer Estate,* 546 A.2d at 786. We hold that neither the supremacy clause nor 31 U.S.C. section 3124(a) prevents the State from taxing the income derived from the repurchase agreements.

Accordingly, I would reverse the judgment of the district court and remand the cause with the direction that the district court declare Revenue Ruling 22-85-1 to be valid.

GRANT, J., Retired, joins in this dissent.

APPENDIX B

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

JOHN LOEWENSTEIN, Plaintiff, v. STATE OF NEBRASKA DEPARTMENT OF REVENUE, Defendant.	Docket 428 Page 177 FINDINGS OF FACT AND CONCLUSIONS OF LAW (Filed Nov. 19, 1990)

This matter came on for trial upon stipulated facts before the undersigned on Monday, July 23, 1990. *Exhibits 1, 2, and 3,* and the attachments thereto, were received by the Court without objection. The parties were directed to submit post-trial briefs, which they have done. The court, being fully advised in the premises, finds as follows:

FINDINGS OF FACT

1. The Trust for Short-Term U.S. Government Securities and the Trust for U.S. Treasury obligations (the "Trusts") are no-load, open-end, diversified investment companies whose primary objective is to receive current income from ownership of U.S. Government securities and obligations, either directly or through the use of repurchase agreements.

2. The Trusts do not engage in any other business.

3. The Trusts are qualified as regulated investment companies under Internal Revenue Code Subchapter M

and are established under the Investment Company Act of 1940.

4. The Trusts are what is commonly known as "mutual funds."

5. The Trusts make U.S. Government securities accessible to investors in much smaller denominations than sold in the marketplace and provide a distribution of the risk through a diversified portfolio of U.S. Government securities.

6. The Trusts invest in short-term securities and obligations of the U.S. Government and its agencies and instrumentalities either directly or through repurchase agreements. The Trusts hold no other securities.

7. The Trusts hold U. S. Government securities and Treasury obligations directly and through repurchase agreements.

8. Each of the federal securities held by the Trusts, either directly or through repurchase agreements, are "obligations of the United States . . . exempt from state income taxes under the laws of the United States" as that term is used in NEB. REV. STAT. § 77-2716 (1988 Cum. Supp.).

9. A typical repurchase agreement used by the Trusts was attached as *Exhibit A* to *Exhibit 2.*

10. A standard repurchase agreement ("repo") consists of a two-part transaction.

11. The first part consists of the transfer of specified securities by the seller to the buyer, in exchange for cash.

12. The second part consists of the contemporaneous agreement by the seller to repurchase the securities at the original sale price, plus an agreed upon amount of "interest," paid on a specified future date (the "Maturity Date").

13. Actual delivery is taken of the securities through the Federal Reserve book entry system.

14. There is no separate promissory note executed in connection with the repurchase agreement.

15. The repurchase price of the government securities subject to a repo is typically less than the market value of the securities.

16. For example, in the case of a two percent differential, the buyer will receive $1,020,000 of securities for the purchase price of $1,000,000.

17. The differential provides a margin of financial security for the buyer in case the securities decline in value and the seller fails to repurchase them.

18. The repurchase price of the securities is equal to the original sale price, plus the negotiated interest.

19. The interest paid by the seller upon repurchase is less than the interest rate accruing on the purchased securities.

20. The income earned on each share of the Trusts is each share's proportionate fractional share of the total income realized from the underlying federal securities and obligations owned by the Trusts, after deducting the administrative costs associated with the U.S. obligations.

21. The Trusts have historically distributed all of their net income to their shareholders.

22. On September 11, 1987, Donald S. Leuenberger, then State Tax Commissioner, issued Revenue Ruling 22-87-4, a copy of which was attached as *Exhibit B* to *Exhibit 2*.

23. This Ruling requires that for tax years after 1986, dividends from regulated investment companies owning obligations of the U.S. Government must be included within taxable income for purposes of the Nebraska Individual Income Tax unless 80 percent or more of the assets of the company for every quarter of the taxable year were directly owned U.S. Government obligations.

24. The defendant has advised taxpayers through the instructions included with the Nebraska Individual Income Tax forms for 1987 and subsequent years that repurchase agreements covering U.S. Government securities cannot be counted towards satisfying the 80 percent requirement of this Revenue Ruling.

25. At the end of each quarter of the tax year in 1987 less than 80 percent of the assets of the Trusts consisted of U.S. securities directly owned by the Trusts.

26. As a result of the foregoing Revenue Ruling, defendant maintains that plaintiff's dividends for 1987 and subsequent years received from the Trusts are subject to the Nebraska state income tax.

CONCLUSIONS OF LAW

1. This is an action for declaratory relief pursuant to NEB. REV. STAT. § 84-911 (1987).

2. The court has jurisdiction over the action and the parties.

3. The liquidity and flexibility provided by repurchase agreements are essential to the efficient functioning of the government securities market.

4. If the State of Nebraska were allowed to impose a tax on income from government obligations that are the subject of a repurchase agreement, it would impair the repurchase market and add to Treasury interest costs.

5. A Nebraska taxpayer is subject to a state income tax on his or her federal adjusted gross income under NEB. REV. STAT. § 77-2715(2) (1988), as modified by § 77-2716.

6. NEB. REV. STAT. § 77-2716(1)(a) exempts from Nebraska income tax "interest or dividends received by the owner of obligations of the United States . . . exempt from state income taxes under the laws of the United States."

7. Rev. Rul. 22-87-4 purports to limit the availability of this exemption to obligations "directly owned."

8. Title 31, U.S.C. § 3124(a), provides that:

> Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax.

9. That provision represents a codification of prior law which was enacted in 1959 as Section 3701 of the Revised Statutes, 31 U.S.C. § 742. In addition to the language set forth above, the law in 1959 included the following language:

> This exemption [from state taxes] extends to every form of taxation that would require that either the [federal] obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax. . . .

Pub. L. 86-346, 105(a), 73 Stat. 622 (1959).

In 1982, when Congress recodified this provision as 31 U.S.C. § 3124(a), the words "directly or indirectly" were "omitted as surplus." H.R. Rep. No. 97-651, 97th Cong. 2d Sess. 94 (1982). The changes in language prompted by the recodification were not intended to make any "substantive change" in existing law. See *Id.* at 1-3. Therefore, although 31 U.S.C. § 3124(a) does not include the phrase "directly or indirectly," the statutory prohibition still extends to state taxes that indirectly, as well as directly, require the consideration of interest earned on, or the value of, federal obligations in their computations.

The limitation contained in Revenue Ruling 22-87-4 purporting to limit the exemption of taxation of interest from federal obligations to obligations "directly owned" violates 31 U.S.C. § 3124 and the Supremacy Clause of the U. S. Constitution.

10. The imposition of the Nebraska income tax on distributions from the Trusts to the Plaintiff reflecting his proportionate share of interest on federal obligations which are the subject of repurchase agreements would violate 31 U.S.C. § 3124(a) and the Supremacy Clause of the U. S. Constitution.

11. Revenue Ruling 22-87-4 is also invalid because it allows for an imposition of the Nebraska state income tax on one hundred percent of the distribution from a regulated investment company unless "for every quarter of the taxable year, 80% or more of the assets of a regulated investment company are directly owned United States government obligations." As a result, the Revenue Ruling allows for the imposition of the Nebraska state income tax on distributions representing the Plaintiff's proportionate share of interest on directly owned United States government obligations if they are part of a fund which cannot meet the 80% test.

12. The imposition of the Nebraska state income tax on any interest derived from United States obligations, regardless of the relative amount involved, is a violation of 31 U.S.C. § 3124 (a) and the Supremacy Clause of the United States Constitution.

IT IS THEREFORE ORDERED, ADJUDGED, AND DECREED that Revenue Ruling 22-87-4 is void and of no effect. Costs are taxed to the Defendant.

DATED this 19th day of November, 1990.

BY THE COURT:

/s/ Donald E. Endacott
Donald E. Endacott,
District Judge

APPENDIX C

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

JOHN LOEWENSTEIN, Plaintiff, vs. STATE OF NEBRASKA DEPARTMENT OF REVENUE, Defendant.	) Docket 428 Page 177 ORDER AMENDING "FINDINGS OF FACT AND CONCLUSIONS OF LAW" AND OVERRULING DEFENDANT'S MOTION FOR NEW TRIAL (Filed Feb. 14, 1991)

This matter came before the court upon the parties' "Joint Motion Amending Pleadings to Conform to the Proof" and upon the defendant's Motion for New Trial. The court has sustained the Joint Motion. Accordingly, the court's "Findings of Fact and Conclusions of Law" are amended by adding the following finding of fact:

22A. On January 26, 1985, Donna Karnes, then State Tax Commissioner, issued Revenue Ruling 22-85-1. This ruling states:

> The interest income received from repurchase agreements involving obligations of the United States Government is income to the investor who provides the funds as a loan secured by Government securities. This interest income which is received from repurchase agreements involving obligations of the United States Government is subject to the Nebraska individual income tax. It is not to be subtracted from a

taxpayer's federal taxable income on the Nebraska return.

The court's findings are further amended by adding the following conclusions of law:

7A. Rev. Rul. 22-85-1 purports to limit the availability of this exemption to obligations which are not the subject of repurchase agreements.

9A. The limitation contained in Revenue Ruling 22-85-1 purporting to limit the exemption of taxation of interest from federal obligations to obligations which are not the subject of repurchase agreements violates 31 U.S.C. § 3124 and the Supremacy Clause of the U. S. Constitution.

Finally, the last paragraph of the court's Order of November 19, 1990 is amended to read as follows:

IT IS THEREFORE ORDERED, ADJUDGED, AND DECREED that Revenue Rulings 22-85-1 and 22-87-4 are void and of no effect. Costs are taxed to the defendant.

Defendant's Motion for New Trial is denied.

DATED this 14th day of February, 1991.

BY THE COURT:

/s/ Donald E. Endacott
Donald Endacott
District Court Judge

PREPARED BY:

CLINE, WILLIAMS, WRIGHT,
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By /s/ Terry R. Wittler
Terry R. Wittler, #15584

APPROVED AS TO FORM ONLY:

DONALD STENBERG,
Attorney General

By /s/ David E. Cygan
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APPENDIX D

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

JOHN LOEWENSTEIN, Plaintiff, v. STATE OF NEBRASKA DEPARTMENT OF REVENUE, Defendant.	) Docket 428 Page 177)))))))	PETITION FOR DECLARATORY JUDGMENT (Filed May 6, 1988)

COMES NOW the plaintiff and for his cause of action alleges as follows:

1. Plaintiff is a citizen of the State of Nebraska and a resident of Lincoln, Lancaster County, Nebraska.

2. Defendant, Department of Revenue, is the duly created agency and instrumentality of the State of Nebraska charged with the administration and collection of the Nebraska income tax.

3. This is an action for declaratory relief pursuant to Neb. Rev. Stat. ~~§ 25-21, 149 (1985 et seq.).~~ 84-911 (1987) challenging the validity of an agency rule. [/s/ TRW 7/1/88]

4. On the 31st day of December, 1986, the plaintiff owned 1,178.64 shares of the Trust for Short-Term U.S. Government Securities at a price per share of $1.00 each. Plaintiff purchased and sold shares of this trust from time to time throughout 1987.

5. On July 14, 1987, plaintiff purchased 4,444.41 shares of the Trust for U.S. Treasury Obligations at a price

per share of $1.00 each. Plaintiff purchased and sold shares of this trust from time to time throughout the remainder of 1987. On the 31st day of December, 1987, the plaintiff owned 17,513.86 shares of this trust.

6. The Trusts are no-load, open-end, diversified investment companies whose primary objective is to receive current income from their investment in U.S. Government securities and obligations. They do not engage in any other business.

7. The Trusts, which are principally located in Pittsburgh, Pennsylvania, are organized as Massachusetts Business Trusts, are qualified as regulated investment companies under Internal Revenue Code Subchapter M, and are established under the Investment Company Act of 1940. They are what is commonly known as "mutual funds."

8. The Trusts make it possible for investors to purchase U.S. Government securities in much smaller denominations than sold in the marketplace, and provide a distribution of the risk through a diversified portfolio. There is no minimum purchase requirement for investors who purchase through a fiduciary, such as a bank trust department.

9. The Trusts invest exclusively in short-term securities and obligations of the U.S. Government and its agencies and instrumentalities. Each of the federal securities held by the Trusts, if owned directly by the Trusts' shareholders, would be exempt from Nebraska income tax.

10. The Trusts invest in U.S. Government securities and Treasury Obligations directly and through repurchase agreements. The Trusts' repurchase agreement provides in Paragraph 18 that the intent of the parties is that the transaction be considered as a sale. Actual delivery is taken of the securities through the Federal Reserve book entry system. There is no promissory note executed in connection with the repurchase agreement, nor is there any indebtedness on behalf of the Trusts to the seller of the federal securities under the repurchase agreement. The sales price of the securities is the market value on the date of the repurchase agreement.

11. The income earned on each share of the Trusts is each share's proportionate fractional share of the total income realized from the underlying federal securities and obligations owned by the trusts, after deducting the administrative costs associated with the U.S. obligations. The Trusts have historically distributed all of their net income to their shareholders.

12. On September 11, 1987, Donald S. Leuenberger, then State Tax Commissioner, issued Revenue Ruling 22-87-4. This Ruling requires that for tax years after 1986, dividends from regulated investment companies owning obligations of the U.S. Government must be included within taxable income for purposes of the Nebraska Individual Income Tax unless 80% or more of the assets of the company for every quarter of the taxable year were directly owned U.S. Government obligations.

13. The defendant has advised taxpayers through the instructions included with the 1987 Nebraska Individual Income Tax forms that repurchase agreements covering U.S. Government securities cannot be counted

towards satisfying the 80% requirement of this Revenue Ruling.

14. In calendar year 1987, Plaintiff received dividends of $129.29, reflecting his share of the income of the Trust for Short-Term U.S. Government Securities and $734.61 reflecting his share of the income of the Trust for Treasurer Obligations.

15. In 1987, less than 80% of the assets of the Trusts consisted of U.S. securities directly owned by the Trusts.

16. As a result of the foregoing Revenue Ruling, defendant intends to impose the Nebraska state income tax on plaintiff's dividends for 1987 received from the Trusts. In addition, plaintiff believes that defendant intends to impose such a tax on any such dividends received by the plaintiff in 1988 and in future years.

17. Any imposition of an income tax by defendant upon the dividends received by plaintiff from the Trusts violates 31 U.S.C. § 3124(a) and the supremacy clause of the U.S. Constitution.

18. Plaintiff does not have an adequate remedy at law.

WHEREFORE, plaintiff prays that the court determine that Revenue Ruling 22-87-4 violates 31 U.S.C. § 3124, Neb. Rev. Stat. § 77-2716 (1987), and the supremacy clause of the U.S. Constitution and further declaring that dividends received by the plaintiff from the Trusts

are not includable within plaintiff's income for purposes of the Nebraska income tax.

JOHN LOEWENSTEIN, Plaintiff

By: CLINE, WILLIAMS, WRIGHT, JOHNSON & OLDFATHER
1900 FirsTier Bank Bldg.
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(402) 474-6900

By: /s/ Terry R. Wittler
Larry A. Holle #11889 and
Terry R. Wittler #15584

APPENDIX E

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

JOHN LOEWENSTEIN, Plaintiff, v. STATE OF NEBRASKA DEPARTMENT OF REVENUE, Defendant.	) Docket 428 Page 177 ANSWER (Filed July 11, 1988)

Defendant State of Nebraska Department of Revenue, for answer to the petition filed herein, admits, denies, and alleges as follows:

1. Admits the allegations in paragraphs 1, 2, 3, 12, and 13.

2. For lack of knowledge, defendant denies the allegations of paragraphs 4, 5, 6, 7, 8, 9, 10, 11, 14, and 15.

3. Admits the allegation of paragraph 16, provided the dividends referred to therein fall within the purview of Revenue Ruling 22-87-4.

4. Denies the allegations of paragraphs 17 and 18.

5. Alleges the imposition of Nebraska income tax on dividends received by plaintiff from the Trusts in question does not violate 31 U.S.C. § 3124, Neb.Rev.Stat. § 77-2716 (Supp. 1987), or the Supremacy Clause of the U. S. Constitution.

WHEREFORE, defendant prays that the court determine that Revenue Ruling 22-87-4 is valid and constitutional in all respects, and does not exceed the statutory authority of the agency. Defendant further prays that the court dismiss plaintiff's petition, at plaintiff's cost.

STATE OF NEBRASKA DEPARTMENT
OF REVENUE, Defendant,

BY ROBERT M. SPIRE, #13977
Attorney General

BY /s/ L. Jay Bartel
L. Jay Bartel, #17247
Assistant Attorney General
2115 State Capitol
Lincoln, NE 68509-4906
Tel: (402) 471-2682

ATTORNEYS FOR DEFENDANT.

CERTIFICATE OF SERVICE

I hereby certify that I have served a copy of the foregoing Answer upon the plaintiff herein by placing a copy of the same in the United States Mail, first class postage prepaid, addressed to plaintiff's attorneys of record, Larry A. Holle and Terry R. Wittler, Cline, Williams, Wright, Johnson & Oldfather, 1900 FirsTier Bank Bldg., Lincoln, NE 68508, on this 11th day of July, 1988.

/s/ L. Jay Bartel
L. Jay Bartel
Assistant Attorney General

APPENDIX F

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

JOHN LOEWENSTEIN, Plaintiff, vs. STATE OF NEBRASKA DEPARTMENT OF REVENUE, Defendant.	) Docket 428 Page 177)) JOINT MOTION AND ORDER AMENDING PLEADINGS TO CONFORM TO THE PROOF)) (Filed Feb. 14, 1991)

The parties jointly move the court for an order pursuant to Neb. Rev. Stat. § 25-852 (1989) conforming the pleadings to the issues actually tried by allowing an amendment instanter by rider to the plaintiff's Petition as follows:

12A. On January 26, 1985, Donna Karnes, then State Tax Commissioner, issued Revenue Ruling 22-85-1. This ruling states:

> The interest income received from repurchase agreements involving obligations of the United States Government is income to the investor who provides the funds as a loan secured by Government securities. This interest income which is received from repurchase agreements involving obligations of the United States Government is subject to the Nebraska individual income tax. It is not to be subtracted from a taxpayer's federal taxable income on the Nebraska return.

The parties further stipulate that the prayer of the plaintiff's Petition be amended to include a request that Revenue Ruling 22-85-1 also be declared invalid.

JOHN LOEWENSTEIN, plaintiff

By CLINE, WILLIAMS, WRIGHT,
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By /s/ Terry R. Wittler
Terry R. Wittler, #15584

STATE OF NEBRASKA DEPARTMENT OF REVENUE, defendant

By DONALD STENBERG,
Attorney General

By /s/ David E. Cygan
David Edward Cygan, #18546
Assistant Attorney General
2115 State Capitol
Lincoln, Nebraska 68509-4906

ORDER

IT IS SO ORDERED this 14th day of February, 1991.

BY THE COURT:

/s/ Donald Endacott
Donald Endacott
District Court Judge

Supreme Court, U.S.
FILED
FEB 10 1994
OFFICE OF THE CLERK

No. 93-823

In The

Supreme Court of the United States

October Term, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE,

Petitioner,

v.

JOHN LOEWENSTEIN,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of Nebraska

BRIEF FOR RESPONDENT IN OPPOSITION

By: Terry R. Wittler
(Counsel of Record)

Cline, Williams, Wright, Johnson & Oldfather
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QUESTION PRESENTED

Whether a Nebraska Department of Revenue ruling which purports to allow a state tax to be imposed on income resulting from the sale of federal obligations pursuant to a repurchase agreement violates 31 U.S.C. § 3124 (1988).

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JURISDICTION

THERE IS NO CASE OR CONTROVERSY SUFFICIENT TO GIVE THIS COURT JURISDICTION.

"The exercise of judicial power under Art III of the Constitution depends on the existence of a case or controversy." *Preiser v. Newkirk*, 422 U.S. 395, 401 (1975). "The case-or-controversy doctrines state fundamental limits on federal judicial power in our system of government." *Allen v. Wright*, 468 U.S. 737, 750 (1984). The state court proceedings which petitioner seeks to challenge do not present such a "case or controversy" and therefore this Court lacks jurisdiction.

On January 26, 1985 the Nebraska State Tax Commissioner issued a nonbinding declaratory ruling, Revenue Ruling No. 22-85-1, dealing with "repurchase agreements involving obligations of the United States government."[1]

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[1] The statutory authority for such rulings is as follows:

> On petition of any interested person, any agency may issue a declaratory ruling with respect to the applicability to any person, property, or state of facts of any rule, regulation, or statute enforceable by it. A declaratory ruling, **if issued after argument and stated to be binding,** shall be binding between the agency and the petitioner on the state of facts alleged unless it is altered or set aside by a court. Such a ruling shall be subject to review in the manner provided in the Administrative Procedure Act for the review of decisions in contested cases. Each agency shall prescribe by rule and regulation the form for such petitions and the procedure for their submission, consideration, and disposition.

Neb. Rev. Stat. § 84-912 (1987) (emphasis added). There is no indication that Revenue Ruling No. 22-85-1 was "issued after

Such a ruling is simply "a written statement issued to the taxpayer that interprets and applies the tax law and regulations to a specific set of facts."[2] This advisory opinion is comparable to a revenue ruling by the United States Internal Revenue Service which "is not binding on courts, since it represents the contention of one party to a case in court and is entitled to no greater weight." M. Saltzman, *IRS Practice and Procedure* ¶ 3.03[2][b], at 3-22 (2d ed. 1991). Indeed, this Court has recognized that "these rulings have no precendential force." *Rowan Cos. v. United States*, 452 U.S. 247, 261 n.17 (1981). The ruling does nothing more than "state the policy of the Department of Revenue in response to specific factual situations submitted by taxpayers."[3] The Nebraska Department of Revenue's policy of treating the taxation of federal securities subject to a repurchase agreement is not a "case or controversy" sufficient to give this Court jurisdiction under article III of the United States Constitution.

This action did not arise from the efforts of the petitioner to collect additional tax from Loewenstein;[4] nor

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argument," nor is the Revenue Ruling expressly "stated to be binding."

[2] Revenue Ruling No. 33-76-2 (approved April 21, 1976) reprinted in CCH Nebraska Tax Reporter ¶ 18-302. Compare 26 C.F.R. § 601.201(a)(2).

[3] Department of Revenue Ruling No. 33-76-2 (approved April 21, 1976), reprinted in CCH Nebraska Tax Reporter ¶ 18-302.

[4] *See Neb. Rev. Stat.* § 77-2776 (1990) which provides that "[i]f the Tax Commissioner finds that the amount of tax shown on the return is less than the correct amount, he shall notify the taxpayer of the amount of the deficiency proposed to be assessed." Indeed, any such actions for tax years 1987, 1988, or 1989 have long since become time barred. *See Neb. Rev. Stat.* § 77-2786 (Supp. 1993) (deficiency determination must be mailed to taxpayer within three years after tax return was due).

has Loewenstein paid a disputed tax and then sought a refund.[5] Respondent's declaratory judgment action simply challenged the petitioner's announced policy with respect to repurchase agreements.[6] As such, this proceeding involves the type of "advisory opinion" that is beyond the jurisdiction of the federal courts.

> Early in its history, this Court held that it had no power to issue advisory opinions . . . and it has frequently repeated that federal courts are without power to decide questions that cannot affect the rights of litigants in the case before them. To be cognizable in a federal court, a suit "must be definite and concrete, touching the legal relations of parties having adverse legal interests. . . . It must be a real and substantial controversy admitting of specific relief through a decree of a conclusive character, as distinguished from an opinion advising what the law would be upon a hypothetical state of facts."

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[5] *See Neb. Rev. Stat.* § 77-2793 (Supp. 1993) which allows for the filing of a claim for refund or credit of any overpayment of the Nebraska income tax.

[6] Respondent did not challenge the facial constitutionality of the Nebraska income tax statute, since it provides an express exclusion for "interest or dividends received by the owner of obligations of the United States . . . exempt from state income taxes under the laws of the United States." *Neb. Rev. Stat.* § 77-2716(1)(a) (Supp. 1993). Nor did respondent challenge the statute, as applied, since no steps have ever been taken to actually collect a tax from respondent based upon the income he received from the Trusts.

North Carolina v. Rice, 404 U.S. 244, 246, (1971), quoting *Aetna Life Ins. Co. v. Harworth*, 300 U.S. 227, 240-41 (1937) (other citations omitted). In the declaratory judgment action below, the revenue ruling which the respondent sought to challenge was nothing more than "an opinion advising what the law would be upon a hypothetical state of facts." Although such a procedure is specifically authorized under Nebraska law,[7] the question of whether this Court has jurisdiction is a question of federal law. *Doremus v. Board of Educ.*, 342 U.S. 429, 434 (1952).

The constitutional requirement of a case or controversy is implicit in the requirement under the applicable jurisdictional statute, 28 U.S.C. § 1257(a), which provides that "[f]inal judgments or decrees rendered by the highest court of a State . . . may be reviewed by the Supreme Court by writ of certiorari . . . where any title, right, privilege, or immunity is specially set up or claimed under the Constitution." Since the State of Nebraska has made no specific claim against Loewenstein, no "right, privilege, or immunity [has been] specially set up or claimed under the Constitution." The state courts below have done nothing more than answer a hypothetical question. That is not sufficient to invoke this Court's jurisdiction under 28 U.S.C. § 1257(a).

The judgment and opinion of the state court below do not purport to be final adjudication on the merits of an actual controversy between the parties. They are nothing more than an abstract statement of what that court believes the law would be in a hypothetical situation.

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[7] *Neb. Rev. Stat.* § 84-911 (1987).

Until the State of Nebraska takes some specific action to attempt to collect the tax at issue, there is no case or controversy between the parties within the meaning of article III of the United States Constitution and accordingly, this Court should deny the petition for writ of certiorari because it lacks jurisdiction.

STATEMENT OF THE CASE

Respondent accepts the petitioner's Statement of the Case.

REASONS FOR DENYING THE WRIT

This Court should deny the petition for writ of certiorari for two reasons. First, there is no substantive disagreement among state high courts about the meaning of federal law which the Court must resolve. The Nebraska Supreme Court's decision was based upon a factual determination that taxation of federal obligations subject to repurchase agreements would adversely and impermissibly affect the borrowing costs of the federal government. This factual issue was not considered or discussed in the cases cited by petitioner.

Second, the decision below is entirely consistent with this Court's decision in *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855 (1983) after the 1959 amendment to the predecessor to 31 U.S.C. § 3124 which did away with "formal but economically meaningless" distinctions in the area of taxation of federal obligations. The

Nebraska Revenue Ruling at issue required exempt federal obligations to be considered or taken into account in violation of 31 U.S.C. § 3124 and the United States Constitution. Therefore, there is no need for this Court to exercise its certiorari jurisdiction merely to restate well recognized federal principles.

I. THERE IS NO CONFLICT AMONG STATE HIGH COURTS ABOUT THE APPLICABLE STATUTORY AND CONSTITUTIONAL PRINCIPLES.

One of the principal purposes for certiorari jurisdiction "is to resolve conflicts among the Circuit Courts of Appeals and state courts concerning the meaning of provisions of federal law." *Braxton v. United States*, 500 U.S. 344, 347 (1991). The Nebraska Supreme Court, like all of the courts which have ruled upon cases involving federal obligations subject to repurchase agreements, recognized the fundamental principle that an "exemption applies to each form of taxation that would require the [federal] obligation, the interest on the obligation, or both, to be considered in computing a tax." 31 U.S.C. § 3124. This case is distinguishable from the cases cited by petitioner because of the Nebraska Supreme Court's **factual** determination that based upon the record before it, imposition of the Nebraska income tax would have an adverse effect on the federal government's ability to raise revenue. Given that factual determination, which was undisputed by petitioner, the decision of the Nebraska court followed as a matter of course from this Court's prior rulings.

This Court has recognized that the statutory exemption is "principally a restatement of the constitutional

rule" which prohibits the states from taxing the federal government. *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983). The focus of the inquiry in such a case should be on whether the proposed tax has a negative effect upon the borrowing power of the federal government. The intergovernmental tax immunity doctrine "is based on the proposition that the borrowing power is an essential aspect of the Federal Government's authority and, just as the Supremacy Clause bars the States from directly taxing federal property, it also bars the States from taxing federal obligations in a manner which has an adverse effect on the United States' borrowing ability." *Rockford Life Ins. Co. v. Illinois Dept. of Revenue*, 482 U.S. 182, 190 (1987).[8] It is the presence of this factual determination which compelled the Nebraska Supreme Court's decision and which distinguishes that decision from cases cited by the petitioner which reached a different result.

The real test in this case is whether imposition of the Nebraska income tax will place a burden, however slight, upon federal obligations. Undisputed expert testimony makes it clear that a Nebraska income tax on federal obligations which are subject to repurchase agreements will make it more difficult and expensive for the federal government to finance the national debt and such a tax is therefore invalid. Peter D. Sternlight, Executive Vice President of the Federal Reserve Bank of New York (E1, 1, 2,

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[8] In *Rockford Life*, this Court's jurisdiction was mandatory under 28 U.S.C. § 1257(2). Otherwise, the Court noted, "[t]he issue presented is not the type that would usually merit our attention if presented in a petition for certiorari." 482 U.S. 184 n.3.

Tab 1, 3:9-23), testified that repurchase agreements play a substantial and important role in the market for United States government securities, and therefore are also extremely important in the process of financing the national debt. (*Id.*, 5:21-6:15).[9] Upon issuance of new government securities, the Federal Reserve distributes the securities to a limited number of "primary dealers" who then act as market-makers for the securities (*Id.*, Exhibit 1 to Sternlight Depo., ¶ 6, App. 3-4). The primary dealers, selected and approved by the Federal Reserve, then sell the federal securities to "secondary dealers," such as savings and loan associations, money market and mutual funds, insurance, financial, and other corporate investors. Secondary dealers, in turn, provide access to investment in the government securities to the public through a variety of mechanisms. In the context of this case, the Trusts are secondary dealers.

Given the current large national debt, vast amounts of United States government securities are issued from time to time. Repurchase agreements provide a financing function allowing dissemination of this huge quantity of debt to the investing public. Federal Reserve operations in the market on a single day through repurchase agreements frequently amount to more than $3 billion to $4 billion per day, and have reached as high as $7.9 billion in

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[9] As this Court noted in construing a predecessor to 31 U.S.C. § 3124, the purpose of the exception is to protect from state taxation "the interest-bearing obligations of the United States which are needed to secure credit to carry on the necessary functions of government." *Smith v. Davis*, 323 U.S. 111, 119 (1944).

a single day. (*Id.*, Exhibit 1 to Sternlight Depo., ¶ 4, App. 3).

Sternlight concluded: "The liquidity and flexibility provided by repurchase agreements are essential to the efficient functioning of the government securities markets." (*Id.*, Exhibit 1 to Sternlight Depo., ¶ 3, App. 2). The underwriting function for United States Treasury issues performed by "primary dealers" would be impaired by the inability to characterize repurchase transactions as sales transactions. Impairment of the repurchase market "would make it less attractive for dealers to perform this very useful underwriting function, *thus adding to Treasury interest costs.*" (*Id.*, Exhibit 1, ¶ 6, emphasis added).

The undisputed expert testimony before the courts below clearly establishes that state taxation of repurchase transactions would "add . . . to Treasury interest costs." This Court has consistently held that such a burden on federal obligations is impermissible. *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983). Therefore, the Nebraska Supreme Court correctly concluded, based upon the factual record before it, that the Revenue Ruling at issue contravened the Constitution and 31 U.S.C. § 3124. There is no divergence of opinion about the meaning of federal law; the Nebraska Supreme Court simply based its decision upon a factual distinction that was not addressed in the decisions relied upon by the petitioner. This Court should not use its certiorari jurisdiction to rule in cases that simply turn upon factual differences. Therefore, the Court should deny the petitioner's request for certiorari.

II. THE DECISION OF THE NEBRASKA SUPREME COURT IS CONSISTENT WITH THIS COURT'S INTERPRETATIONS OF 31 U.S.C. § 3124.

Prior to 1959 there existed a "formal but economically meaningless distinction between taxes on Government obligations and taxes on separate interests." *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 858 (1983). In 1959 Congress amended the applicable statute and "set aside this Court's rather formalistic pre-1959 approach." *Id.* at 862. "Under the plain language of the 1959 amendment, however, the tax is barred regardless of its *form* if federal obligations must be considered, either directly or indirectly, in *computing* the tax." *Id.*

In striking down a Texas bank share taxation scheme because it failed to exclude from consideration federal obligations owned by the banks, this Court noted that the "exemption" for federal obligations is sweeping:

> [I]t "extends to *every form* of taxation that would require that either the obligations or the interest thereon, or both, *be considered, directly or indirectly, in the computation of the tax*" (emphasis supplied). *See Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 395-96 (the statute "establishes a broad exemption").

Id.

Under the statute, "considering" means "taken into account or included in the accounting." *Id.* The issue, therefore, is not the formal one of determining who "owns" the government obligations that are the subject of a repurchase agreement. Rather, the question is whether

taxation of the Trusts' income from purchasing and selling federal obligations subject to repurchase agreements is a form of taxation requiring either the obligations or the interest thereon or both to be considered directly or indirectly in the computation of the tax. Clearly it is and the prohibition of taxing federal obligations is therefore violated.

The Trusts in this case earn no income when they first enter into a repurchase agreement. Indeed, all that occurs is that the Trusts transfer cash to the seller and the federal obligations are transferred to a custodian for the Trusts (E2, 1, 2, Tab 2, ¶¶ 10-13). The Trusts only earn income at the conclusion of the transaction. This occurs in one of two ways. If the seller defaults and fails to repurchase the federal obligations, the Trusts sell those obligations with the intention of recovering the original purchase price plus some additional earned compensation to reflect the time value of money. At this point the Trusts would clearly have realized income requiring consideration of "either the obligations or the interest thereon, or both" which would be exempt from taxation by the State.

The other and presumably more common alternative is for the original seller to carry out its obligations and repurchase the government obligations at the agreed-upon price. (*Id.*, ¶ 18). The Trusts' profit on this resale reflects income earned by them in consideration of their holding of government obligations just as surely as the income they would receive in the first instance in the event of a default. *In either event the Trusts earn no income until they transfer the government obligations.* The economic reality is that whatever income the Trusts derive from these transactions arises in consideration of the federal

obligations that are the subject of the transaction. As a result that income must be exempt from taxation by the State of Nebraska.

CONCLUSION

For all the foregoing reasons, respondent respectfully requests that the petition for writ of certiorari be denied.

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UNITED STATES DISTRICT COURT*
FOR THE DISTRICT OF NEW JERSEY

In the Matter of: BEVILL, BRESLER & SCHULMAN ASSET MANAGEMENT CORPORATION, Debtor.	(Hon. Dickinson R. Debevoise) Civ. No. 85-1728 Chapter 11
SAUL S. COHEN, Trustee of Bevill, Bresler & Schulman Asset Management Corporation, Plaintiff, vs. ARMY MORAL SUPPORT FUND, et al., Defendants.	Adversary Proceeding No. 85-2103 Civ. No. 85-2224 Adversary Proceeding No. 85-5274
In re: BEVILL, BRESLER & SCHULMAN, INC., Debtor.	
RICHARD W. HILL, Trustee for the liquidation of Bevill, Bresler & Schulman, Inc., Plaintiff, vs. FIDELITY NEW YORK, F.A., et al., Defendants.	

*Sternlight's affidavit from the *Bevill, Bresler* bankruptcy was Exhibit 1 to his deposition which was received in evidence in this case by stipulation as an attachment to the "First Stipulation of the Parties," Exhibit 1 in the trial below.

STATE OF NEW YORK)
) ss:
COUNTY OF NEW YORK)

AFFIDAVIT OF PETER D. STERNLIGHT

1. I am Executive Vice President of the Federal Reserve Bank of New York ("FRBNY") with responsibility for the Open Market Operations Function.

2. I have had experience at the FRBNY's open market trading desk since the 1960's, and for the past six years I have been Manager of the System Open Market Account ("SOMA"). In that capacity, I have responsibility for a variety of types of transactions undertaken by the FRBNY open market desk for the account of SOMA. The object of those transactions is to adjust the level of bank reserves in order to achieve the Federal Open Market Committee's monetary policy goals. FRBNY also carries out transactions in the market on behalf of foreign central banks to aid them in their dollar investments.

3. Repurchase agreements involving United States Treasury issues and certain other agency issues are essential to the operations of the open market desk for reserve adjustments. In addition, the liquidity and flexibility provided by repurchase agreements are essential to the efficient functioning of the government securities markets. Repurchase agreements are unique vehicles for short-term, high-volume financing. As used in the market today, repurchase agreements are viewed generally as contracts for the sale of securities and their resale back to the original seller at a future date. An essential feature of this arrangement is that securities delivered under a

repurchase agreement are freely transferable and unencumbered by restriction from previous transfers.

4. During 1985, the FRBNY conducted SOMA transactions in the market in the aggregate amount of $212 billion. Of these, 74 percent were repurchase transactions, and 17 percent were reverse repurchase transactions (known to FRBNY as matched sale-purchase agreements). Thus, only 9 percent of the 1985 SOMA market transactions conducted by the FRBNY were conducted without the use of repurchase or reverse repurchase agreements. Also during 1985, the FRBNY conducted $188 billion worth of transactions in the market on behalf of approximately 150 foreign central banks and other foreign official institutions. Of these, some 62 percent were repurchase transactions. Federal Reserve operations in the market on a single day through repos or reverse repos often come to $3-4 billion and have reached as high as 7.9 billion.

5. The FRBNY repurchase transactions are, by statute, structured and conducted as contracts for purchase-and-sale. The high volume of Federal Reserve open market operations requires the broadest possible repurchase market for government securities. It is doubtful that the FRBNY would have access to a market for repurchase agreements characterized as secured loans. Such a result could impair the FRBNY's ability to maintain appropriate levels of bank reserves from week to week, diminish the FRBNY's ability to achieve reserve growth objectives, and possibly accentuate interest rate volatility.

6. Repurchase agreements are an important method for dealer financing of their inventories of United States

government securities. The primary dealers typically underwrite a sizeable portion of new Treasury issues – 35-75 percent – and rely heavily on temporary financing through repurchase agreements pending resale of the issues to other investors. Clearly, an impairment of the repo market would make it less attractive for dealers to perform this very useful underwriting function, thus adding to Treasury interest costs.

7. Repurchase agreements are a major vehicle in the market-making process, providing the means for creating hedges and arbitrages among various issues and thereby increasing liquidity. Through these transactions, the dealer market adds to the close substitutability among Treasury issues, enhancing the attractiveness of the market for a variety of participants, which in turn increases the market for Treasury issues. If repurchase agreements were to lose their present characteristics of flexibility and liquidity, the dealer market – a critical element in the process of financing the national debt through Treasury issues – would be handicapped. More generally, a hobbling of the repo market could have broad rate effects throughout the financial markets, diminishing efficiency and the allocation of resources. Market participants would turn to less liquid forms of investment that would tend to produce higher rates in the economy at large. Greater volatility of rates as a consequence of a diminished repo market could add to average rate levels.

8. Repurchase agreements have proven to be invaluable to a wide variety of institutional investors, both public and private. A significant number of participants in the market are public entities who face constitutional, statutory, or regulatory restrictions on lending and

borrowing activities, but can and do rely on repurchase agreements to achieve investment, cash management and liquidity needs. If repurchase agreements, with their present characteristics (including unencumbered transferability of securities delivered under repo contract), and in their present form and as presently understood in the market (contracts for the sale and repurchase of securities) were unavailable to these participants in the market, the more costly financing alternatives would have adverse consequences for the entities involved, and their withdrawal from the government securities market as repurchase participants would adversely impact the market.

9. Repurchase agreements, as used and understood by the FRBNY in conformity with recognized and accepted market practice, are agreements for the transfer of securities with a simultaneously executed agreement to retransfer securities back to the original seller at a specified future date. They are structured and treated as sales and repurchases, unencumbered by any restriction from prior transfer that would impede further transfer. This treatment is essential to the purposes for which repurchase agreements are employed: high-volume, short-term financing transactions.

/s/ Peter D. Sternlight
Peter D. Sternlight

Subscribed and sworn
to before me this 11th
day of April, 1986
/s/ Margaret M. Manuel
Notary Public

MARGARET M. MANUEL
Notary Public, State of New York
No. 31-4825941
Qualified in Nassau County
Certificate Filed in New York County
Commission Expires May 31, 1988

Supreme Court, U.S.
FILED
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(3)

No. 93-823

In The

Supreme Court of the United States

October Term, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE,

Petitioner,

v.

JOHN LOEWENSTEIN,

Respondent.

Petition For A Writ Of Certiorari To The Supreme Court Of Nebraska

REPLY BRIEF FOR PETITIONER

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No. 93-823

In The

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JOHN LOEWENSTEIN,

Respondent.

Petition For A Writ Of Certiorari To The Supreme Court Of Nebraska

REPLY BRIEF FOR PETITIONER

As demonstrated in the Petition, the decision of the Supreme Court of Nebraska that a state tax on income derived from repurchase agreements involving federal securities violates 31 U.S.C. § 3124 is contrary to numerous decisions of courts of other states, and conflicts with decisions of this Court. Respondent argues the decision below is distinguishable from cases decided by other state courts because it is "based upon a factual determination that taxation of federal obligations subject to repurchase agreements would adversely and impermissibly affect the borrowing costs of the federal government." (Brief in Opp. at 5). Respondent also argues the Nebraska Supreme Court's decision is "consistent with this Court's decision in *American Bank & Trust Co. v. Dallas County,* 463

U.S. 855 (1983). . . . " (Brief in Opp. at 5). Respondent also suggests this Court lacks jurisdiction to grant the Petition because the decision below is assertedly a mere "advisory opinion" which does not satisfy the case or controversy requirement of Article III of the U.S. Constitution. (Brief in Opp. at 1-5). None of these contentions provide any basis for denying the Petition.

1. Respondent suggests that this Court lacks jurisdiction to grant the Petition because the decision below did not arise from an actual "case or controversy" as required by Article III of the United States Constitution. Respondent argues the Nebraska Supreme Court did nothing more than render an "advisory opinion" on a hypothetical set of facts. (Brief in Opp. at 3-4). Respondent's contentions are without merit.

Respondent brought this action challenging the validity of a ruling by the Nebraska Department of Revenue pursuant to Neb. Rev. Stat. § 84-911 (1987) (Pet. Cert. App. A-30).[1] Section 84-911(1) provides:

> The validity of any rule or regulation may be determined upon a petition for declaratory judgment thereon addressed to the district court of Lancaster County **if it appears that the rule or regulation or its threatened application interferes with or impairs or threatens to interfere with or impair the legal rights or privileges of the petitioner.** The agency shall be made a party to the proceeding. **The declaratory judgment shall be rendered whether or not the petitioner has first requested the agency to pass upon the validity of the rule or regulation in question.** (emphasis added).

[1] Respondent erroneously refers to Neb. Rev. Stat. § 84-912 (1987), which establishes a procedure to obtain a declaratory ruling from an administrative agency as to the applicability of a rule, regulation, or statute. Respondent did not seek a declaratory ruling from the Nebraska Department of Revenue, but filed an action seeking a declaratory judgment in state district court under § 84-911. Section 84-912 is simply irrelevant.

In order to invoke the jurisdiction of the state court, Respondent alleged that, as a result of the Department's Ruling, the Department "intend[ed] to impose the Nebraska state income tax on plaintiff's dividends for 1987 received from the Trusts . . . ", and that "defendant intend[ed] to impose such a tax on any such dividends received by plaintiff in 1988 and in future years." (Pet. Cert. App. A-33). Respondent further alleged that "[a]ny imposition of an income tax by defendant upon the dividends received by plaintiff from the Trusts violate[ed] 31 U.S.C. § 3124(a) and the supremacy clause of the U.S. Constitution." (Pet. Cert. App. A-33). Respondent requested relief "declaring that dividends received by plaintiff from the Trusts are not includable within plaintiff's income for purposes of the Nebraska income tax." (Pet. Cert. App. A-33-34). The Department admitted its intent to enforce the Ruling and to impose the tax in question. (Pet. Cert. App. A-35).[2]

Respondent's challenge to the validity of the Department's Ruling plainly presented an actual case or

[2] Originally, Respondent challenged only the Department's Revenue Ruling 22-87-4. Subsequently, the parties jointly filed a motion to amend pleadings to include a request that the validity of Revenue Ruling 22-85-1 be determined. (Pet. Cert. App. A-37-38).

controversy ripe for decision by the courts below, and the decision of the Nebraska Supreme Court is subject to review by this Court. Respondent brought this action under § 84-911 to obtain a declaratory judgment as to the validity of a rule of the Department which Respondent alleged would be enforced against him and would impair or interfere with his legal rights. Respondent had a "personal stake in the outcome", thus "assur[ing] that concrete adverseness which sharpens the presentation of issues" necessary for proper resolution of the federal questions presented. *Baker v. Carr,* 369 U.S. 186, 204 (1962). Respondent also demonstrated that he "ha[d] sustained or [was] immediately in danger of sustaining some direct injury" as a result of the challenged official conduct and that the injury or threatened injury was "real and immediate," not "conjectural" or "hypothetical." *City of Los Angeles v. Lyons,* 461 U.S. 95, 102 (1983).[3]

---

[3] Respondent asserts that he was not required by Petitioner to pay taxes on income from the Trusts, and that he did not do so. (Brief in Opp. at 2-3). This is directly contrary to the facts as found by the court below. *Loewenstein v. State,* 244 Neb. 82, 86, 504 N.W.2d 800, 803 (1993). ("The controversy in this case arose out of the State's taxation of income of appellee, John Loewenstein, received from investments in mutual funds."). Even absent this finding, there would be no relevance to Respondent's apparent claim that no justiciable controversy exists because certain prior tax years may be barred from assessment by Neb. Rev. Stat. § 77-2786 (Supp. 1993). The decision does impact Petitioner's ability to assess taxes for later tax years, as the court below specifically held "that the income received by the [Respondent] from repo transactions executed by the trusts involving federal securities is exempt from state taxation under § 3124." 244 Neb. at 90, 504 N.W.2d at 805.

The Nebraska Supreme Court "has repeatedly held that courts of this state are not permitted to give advisory opinions but can only declare the law and its application to a given set of facts when a justiciable controversy is presented for the determination of the court." *State ex rel. Nebraska Nurses Ass'n v. State Bd. of Nursing,* 205 Neb. 792, 798, 290 N.W.2d 453, 456 (1980). "The courts of [Nebraska] decide controversies and are not empowered to render advisory opinions." *American Fed. of S., C., and M. Emp. v. State,* 200 Neb. 171, 177, 263 N.W.2d 643, 647 (1978). The declaratory judgment rendered by the state court was based on a justiciable case or controversy as to Petitioner's taxation of income received by Respondent.

Finally, there is no merit to Respondent's claim that the requirements of the applicable jurisdictional statute, 28 U.S.C. § 1257(a), are not satisfied. This section provides for review by petition for certiorari of "[f]inal judgments or decrees rendered by the highest court of a State . . . where any title, right, privilege, or immunity is specially set up or claimed under the Constitution . . . or statutes of . . . the United States." In this case, Respondent claimed a right to immunity from state taxation under a federal statute (31 U.S.C. § 3124) and the U.S. Constitution (the Supremacy Clause). The state court's judgment falls squarely within the confines of the jurisdictional statute.

2. As to the merits, Respondent does not dispute that a conflict exists among the highest courts of several states as to whether state taxation of income derived from repurchase agreements involving federal securities violates 31 U.S.C. § 3124. Respondent does assert, however, that the Court should not grant certiorari because of the

Nebraska Supreme Court's reliance on factual determinations which Respondent claims distinguishes this case from decisions in other jurisdictions. (Brief in Opp. at 6-9). In particular, Respondent refers to the assertedly "undisputed expert testimony" of Peter D. Sternlight cited by the majority below. (Brief in Opp. at 9).

The evidence presented in the proceedings below, in addition to those facts stipulated by the parties, consisted primarily of depositions of Stewart Brown, a financial analyst and university professor, and Peter Sternlight, executive vice president of the Federal Reserve Bank in New York. 244 Neb. at 86, 504 N.W.2d at 803. These depositions were part of the evidence before the Florida court in *Department of Revenue v. Page*, 541 So. 2d 1270 (Fla. Dist. Ct. App. 1989), which involved the same issue litigated ~~in~~ the court below. 244 Neb. at 86, 504 N.W.2d at 803. In *Page*, the Florida court, having before it virtually the same evidence presented in this case, held that the state was **not** precluded from taxing income from shares in the Trusts derived from repurchase agreements. 541 So. 2d at 1275. Thus, not only is the decision of the court below contrary to numerous state court decisions which have rejected claims that the exemption from taxation of federal obligations under § 3124 precluded state taxation of income from repurchase transactions, it is at odds with at least one state court decision which involved virtually the same evidentiary record presented in this case. Respondent's proffered "factual distinction" provides no basis for the Court to decline to grant the petition.

Moreover, Respondent is plainly incorrect in characterizing the deposition testimony of Mr. Sternlight as "undisputed expert testimony." The decision below

recounts that Mr. Brown "testified that the economic substance of a repurchase transaction is a secured loan . . . ", and "that the Federal Reserve could still conduct open-market operations in essentially the same way without repurchase agreements." 244 Neb. at 86, 504 N.W.2d at 803. Thus, it cannot be said that Mr. Sternlight's testimony was in any sense "undisputed."

3. Finally, Respondent argues that the decision below is consistent with this Court's decisions interpreting the scope of the immunity provided under § 3124, citing specifically the Court's decision in *American Bank and Trust Co. v. Dallas County*, 463 U.S. 855 (1983). (Brief in Opp. at 10). Respondent wholly ignores the Court's later decision in *Rockford Life Ins. Co. v. Illinois Dep't. of Revenue*, 482 U.S. 182 (1987). In *Rockford Life*, the Court held that only those instruments which constituted "direct [ ]or certain obligations of the United States" which the United States bore "the primary obligation to make timely payments" on were immune under § 3124. *Id.* at 188. As noted in the Petition, there is no direct and certain obligation of the United States government to the Trusts under the repurchase agreements. The agreements, by their terms, specify that the Trusts will not receive the monies promised by the federal government in the securities which are the subject of the repurchase transaction. The federal government never receives the proceeds of repurchase transactions. The proceeds flow between private parties, the underlying obligations already having been issued at the time the repurchase transaction takes place. Under the reasoning of the Court in *Rockford Life*,

state taxation of income from repurchase transactions is not contrary to 31 U.S.C. § 3124.

CONCLUSION

The Petition should be granted.

Respectfully submitted,

State of Nebraska,
Department of Revenue,
Petitioner

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In The

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October Term, 1993

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Petitioner,

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JOHN LOEWENSTEIN,

Respondent.

On Writ Of Certiorari
To The Supreme Court Of Nebraska

JOINT APPENDIX

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3/22/91	Bill of Exceptions filed.
7/3/91	Brief filed by Appellant.
7/29/91	Replacement brief filed by Appellant.
9/3/91	Brief filed by Appellee John Loewenstein.
9/17/91	Reply brief filed by Appellant.
6/8/93	Oral argument heard.
8/27/93	Published Opinion filed. Affirmed. White, J. (Caporale and Grant, J., dissenting).
9/3/93	Application to Stay Mandate filed by Appellant.
10/6/93	Order overruling Application to Stay Mandate.
10/13/93	Mandate issued.

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District Court of Lancaster County, Nebraska

John Loewenstein v. State of Nebraska, Dept. of Revenue 428-177

5/6/88	Petition for Declaratory Judgment filed by Plaintiff John Loewenstein.
6/15/88	Demurrer filed by Defendant State of Nebraska, Department of Revenue.
7/1/93	Petition for Declaratory Judgment amended by interlineation instanter; demurrer withdrawn.
7/11/88	Answer filed by Defendant.
7/18/88	Reply filed by Plaintiff.
6/4/90	Defendant's Motion for Partial Summary Judgment filed.
7/23/90	Trial held on Stipulated Facts.
11/19/90	Findings of Fact and Conclusions of Law filed.
11/29/90	Motion for New Trial filed by Defendant.
2/14/91	Joint Motion and Order Amending Pleadings to Conform to Proof filed; Order Amending "Findings of Fact and Conclusions of Law" and Overruling Defendant's Motion for New Trial entered.
3/14/91	Notice of Appeal filed by Defendant.

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

JOHN LOEWENSTEIN, Plaintiff, v. STATE OF NEBRASKA DEPARTMENT OF REVENUE, Defendant.	) Docket 428 Page 177))))))) PETITION FOR DECLARATORY JUDGMENT (Filed May 6, 1988)

COMES NOW the plaintiff and for his cause of action alleges as follows:

1. Plaintiff is a citizen of the State of Nebraska and a resident of Lincoln, Lancaster County, Nebraska.

2. Defendant, Department of Revenue, is the duly created agency and instrumentality of the State of Nebraska charged with the administration and collection of the Nebraska income tax.

3. This is an action for declaratory relief pursuant to Neb. Rev. Stat. ~~§ 25-21, 149 (1985 et seq.).~~ 84-911 (1987) challenging the validity of an agency rule. [/s/ TRW 7/1/88]

4. On the 31st day of December, 1986, the plaintiff owned 1,178.64 shares of the Trust for Short-Term U.S. Government Securities at a price per share of $1.00 each. Plaintiff purchased and sold shares of this trust from time to time throughout 1987.

5. On July 14, 1987, plaintiff purchased 4,444.41 shares of the Trust for U.S. Treasury Obligations at a price

per share of $1.00 each. Plaintiff purchased and sold shares of this trust from time to time throughout the remainder of 1987. On the 31st day of December, 1987, the plaintiff owned 17,513.86 shares of this trust.

6. The Trusts are no-load, open-end, diversified investment companies whose primary objective is to receive current income from their investment in U.S. Government securities and obligations. They do not engage in any other business.

7. The Trusts, which are principally located in Pittsburgh, Pennsylvania, are organized as Massachusetts Business Trusts, are qualified as regulated investment companies under Internal Revenue Code Subchapter M, and are established under the Investment Company Act of 1940. They are what is commonly known as "mutual funds."

8. The Trusts make it possible for investors to purchase U.S. Government securities in much smaller denominations than sold in the marketplace, and provide a distribution of the risk through a diversified portfolio. There is no minimum purchase requirement for investors who purchase through a fiduciary, such as a bank trust department.

9. The Trusts invest exclusively in short-term securities and obligations of the U.S. Government and its agencies and instrumentalities. Each of the federal securities held by the Trusts, if owned directly by the Trusts' shareholders, would be exempt from Nebraska income tax.

10. The Trusts invest in U.S. Government securities and Treasury Obligations directly and through repurchase agreements. The Trusts' repurchase agreement provides in Paragraph 18 that the intent of the parties is that the transaction be considered as a sale. Actual delivery is taken of the securities through the Federal Reserve book entry system. There is no promissory note executed in connection with the repurchase agreement, nor is there any indebtedness on behalf of the Trusts to the seller of the federal securities under the repurchase agreement. The sales price of the securities is the market value on the date of the repurchase agreement.

11. The income earned on each share of the Trusts is each share's proportionate fractional share of the total income realized from the underlying federal securities and obligations owned by the trusts, after deducting the administrative costs associated with the U.S. obligations. The Trusts have historically distributed all of their net income to their shareholders.

12. On September 11, 1987, Donald S. Leuenberger, then State Tax Commissioner, issued Revenue Ruling 22-87-4. This Ruling requires that for tax years after 1986, dividends from regulated investment companies owning obligations of the U.S. Government must be included within taxable income for purposes of the Nebraska Individual Income Tax unless 80% or more of the assets of the company for every quarter of the taxable year were directly owned U.S. Government obligations.

13. The defendant has advised taxpayers through the instructions included with the 1987 Nebraska Individual Income Tax forms that repurchase agreements covering U.S. Government securities cannot be counted

towards satisfying the 80% requirement of this Revenue Ruling.

14. In calendar year 1987, Plaintiff received dividends of $129.29, reflecting his share of the income of the Trust for Short-Term U.S. Government Securities and $734.61 reflecting his share of the income of the Trust for Treasurer Obligations.

15. In 1987, less than 80% of the assets of the Trusts consisted of U.S. securities directly owned by the Trusts.

16. As a result of the foregoing Revenue Ruling, defendant intends to impose the Nebraska state income tax on plaintiff's dividends for 1987 received from the Trusts. In addition, plaintiff believes that defendant intends to impose such a tax on any such dividends received by the plaintiff in 1988 and in future years.

17. Any imposition of an income tax by defendant upon the dividends received by plaintiff from the Trusts violates 31 U.S.C. § 3124(a) and the supremacy clause of the U.S. Constitution.

18. Plaintiff does not have an adequate remedy at law.

WHEREFORE, plaintiff prays that the court determine that Revenue Ruling 22-87-4 violates 31 U.S.C. § 3124, Neb. Rev. Stat. § 77-2716 (1987), and the supremacy clause of the U.S. Constitution and further declaring that dividends received by the plaintiff from the Trusts

are not includable within plaintiff's income for purposes of the Nebraska income tax.

JOHN LOEWENSTEIN, Plaintiff

By: CLINE, WILLIAMS, WRIGHT, JOHNSON & OLDFATHER
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Lincoln, NE 68508
(402) 474-6900

By: /s/ Terry R. Wittler
Larry A. Holle #11889 and
Terry R. Wittler #15584

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

JOHN LOEWENSTEIN, Plaintiff, v. STATE OF NEBRASKA DEPARTMENT OF REVENUE, Defendant.	) Docket 428 Page 177) ANSWER) (Filed July 11, 1988)

Defendant State of Nebraska Department of Revenue, for answer to the petition filed herein, admits, denies, and alleges as follows:

1. Admits the allegations in paragraphs 1, 2, 3, 12, and 13.

2. For lack of knowledge, defendant denies the allegations of paragraphs 4, 5, 6, 7, 8, 9, 10, 11, 14, and 15.

3. Admits the allegation of paragraph 16, provided the dividends referred to therein fall within the purview of Revenue Ruling 22-87-4.

4. Denies the allegations of paragraphs 17 and 18.

5. Alleges the imposition of Nebraska income tax on dividends received by plaintiff from the Trusts in question does not violate 31 U.S.C. § 3124, Neb.Rev.Stat. § 77-2716 (Supp. 1987), or the Supremacy Clause of the U. S. Constitution.

WHEREFORE, defendant prays that the court determine that Revenue Ruling 22-87-4 is valid and constitutional in all respects, and does not exceed the statutory authority of the agency. Defendant further prays that the court dismiss plaintiff's petition, at plaintiff's cost.

STATE OF NEBRASKA DEPARTMENT OF REVENUE, Defendant,

BY ROBERT M. SPIRE, #13977
Attorney General

BY /s/ L. Jay Bartel
L. Jay Bartel, #17247
Assistant Attorney General
2115 State Capitol
Lincoln, NE 68509-4906
Tel: (402) 471-2682

ATTORNEYS FOR DEFENDANT.

CERTIFICATE OF SERVICE

I hereby certify that I have served a copy of the foregoing Answer upon the plaintiff herein by placing a copy of the same in the United States Mail, first class postage prepaid, addressed to plaintiff's attorneys of record, Larry A. Holle and Terry R. Wittler, Cline, Williams, Wright, Johnson & Oldfather, 1900 FirsTier Bank Bldg., Lincoln, NE 68508, on this 11th day of July, 1988.

/s/ L. Jay Bartel
L. Jay Bartel
Assistant Attorney General

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

JOHN LOEWENSTEIN, Plaintiff, v. STATE OF NEBRASKA DEPARTMENT OF REVENUE, Defendant.	)	Docket 428 Page 177 FINDINGS OF FACT AND CONCLUSIONS OF LAW (Filed Nov. 19, 1990)

This matter came on for trial upon stipulated facts before the undersigned on Monday, July 23, 1990. *Exhibits 1, 2, and 3*, and the attachments thereto, were received by the Court without objection. The parties were directed to submit post-trial briefs, which they have done. The court, being fully advised in the premises, finds as follows:

FINDINGS OF FACT

1. The Trust for Short-Term U.S. Government Securities and the Trust for U.S. Treasury obligations (the "Trusts") are no-load, open-end, diversified investment companies whose primary objective is to receive current income from ownership of U.S. Government securities and obligations, either directly or through the use of repurchase agreements.

2. The Trusts do not engage in any other business.

3. The Trusts are qualified as regulated investment companies under Internal Revenue Code Subchapter M

and are established under the Investment Company Act of 1940.

4. The Trusts are what is commonly known as "mutual funds."

5. The Trusts make U.S. Government securities accessible to investors in much smaller denominations than sold in the marketplace and provide a distribution of the risk through a diversified portfolio of U.S. Government securities.

6. The Trusts invest in short-term securities and obligations of the U.S. Government and its agencies and instrumentalities either directly or through repurchase agreements. The Trusts hold no other securities.

7. The Trusts hold U. S. Government securities and Treasury obligations directly and through repurchase agreements.

8. Each of the federal securities held by the Trusts, either directly or through repurchase agreements, are "obligations of the United States . . . exempt from state income taxes under the laws of the United States" as that term is used in NEB. REV. STAT. § 77-2716 (1988 Cum. Supp.).

9. A typical repurchase agreement used by the Trusts was attached as *Exhibit A* to *Exhibit 2*.

10. A standard repurchase agreement ("repo") consists of a two-part transaction.

11. The first part consists of the transfer of specified securities by the seller to the buyer, in exchange for cash.

12. The second part consists of the contemporaneous agreement by the seller to repurchase the securities at the original sale price, plus an agreed upon amount of "interest," paid on a specified future date (the "Maturity Date").

13. Actual delivery is taken of the securities through the Federal Reserve book entry system.

14. There is no separate promissory note executed in connection with the repurchase agreement.

15. The repurchase price of the government securities subject to a repo is typically less than the market value of the securities.

16. For example, in the case of a two percent differential, the buyer will receive $1,020,000 of securities for the purchase price of $1,000,000.

17. The differential provides a margin of financial security for the buyer in case the securities decline in value and the seller fails to repurchase them.

18. The repurchase price of the securities is equal to the original sale price, plus the negotiated interest.

19. The interest paid by the seller upon repurchase is less than the interest rate accruing on the purchased securities.

20. The income earned on each share of the Trusts is each share's proportionate fractional share of the total income realized from the underlying federal securities and obligations owned by the Trusts, after deducting the administrative costs associated with the U.S. obligations.

21. The Trusts have historically distributed all of their net income to their shareholders.

22. On September 11, 1987, Donald S. Leuenberger, then State Tax Commissioner, issued Revenue Ruling 22-87-4, a copy of which was attached as *Exhibit B* to *Exhibit 2*.

23. This Ruling requires that for tax years after 1986, dividends from regulated investment companies owning obligations of the U.S. Government must be included within taxable income for purposes of the Nebraska Individual Income Tax unless 80 percent or more of the assets of the company for every quarter of the taxable year were directly owned U.S. Government obligations.

24. The defendant has advised taxpayers through the instructions included with the Nebraska Individual Income Tax forms for 1987 and subsequent years that repurchase agreements covering U.S. Government securities cannot be counted towards satisfying the 80 percent requirement of this Revenue Ruling.

25. At the end of each quarter of the tax year in 1987 less than 80 percent of the assets of the Trusts consisted of U.S. securities directly owned by the Trusts.

26. As a result of the foregoing Revenue Ruling, defendant maintains that plaintiff's dividends for 1987 and subsequent years received from the Trusts are subject to the Nebraska state income tax.

CONCLUSIONS OF LAW

1. This is an action for declaratory relief pursuant to NEB. REV. STAT. § 84-911 (1987).

2. The court has jurisdiction over the action and the parties.

3. The liquidity and flexibility provided by repurchase agreements are essential to the efficient functioning of the government securities market.

4. If the State of Nebraska were allowed to impose a tax on income from government obligations that are the subject of a repurchase agreement, it would impair the repurchase market and add to Treasury interest costs.

5. A Nebraska taxpayer is subject to a state income tax on his or her federal adjusted gross income under NEB. REV. STAT. § 77-2715(2) (1988), as modified by § 77-2716.

6. NEB. REV. STAT. § 77-2716(1)(a) exempts from Nebraska income tax "interest or dividends received by the owner of obligations of the United States . . . exempt from state income taxes under the laws of the United States."

7. Rev. Rul. 22-87-4 purports to limit the availability of this exemption to obligations "directly owned."

8. Title 31, U.S.C. § 3124(a), provides that:

> Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax.

9. That provision represents a codification of prior law which was enacted in 1959 as Section 3701 of the Revised Statutes, 31 U.S.C. § 742. In addition to the language set forth above, the law in 1959 included the following language:

> This exemption [from state taxes] extends to every form of taxation that would require that either the [federal] obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax. . . .

Pub. L. 86-346, 105(a), 73 Stat. 622 (1959).

In 1982, when Congress recodified this provision as 31 U.S.C. § 3124(a), the words "directly or indirectly" were "omitted as surplus." H.R. Rep. No. 97-651, 97th Cong. 2d Sess. 94 (1982). The changes in language prompted by the recodification were not intended to make any "substantive change" in existing law. See *Id.* at 1-3. Therefore, although 31 U.S.C. § 3124(a) does not include the phrase "directly or indirectly," the statutory prohibition still extends to state taxes that indirectly, as well as directly, require the consideration of interest earned on, or the value of, federal obligations in their computations.

The limitation contained in Revenue Ruling 22-87-4 purporting to limit the exemption of taxation of interest from federal obligations to obligations "directly owned" violates 31 U.S.C. § 3124 and the Supremacy Clause of the U. S. Constitution.

10. The imposition of the Nebraska income tax on distributions from the Trusts to the Plaintiff reflecting his proportionate share of interest on federal obligations which are the subject of repurchase agreements would violate 31 U.S.C. § 3124(a) and the Supremacy Clause of the U. S. Constitution.

11. Revenue Ruling 22-87-4 is also invalid because it allows for an imposition of the Nebraska state income tax on one hundred percent of the distribution from a regulated investment company unless "for every quarter of the taxable year, 80% or more of the assets of a regulated investment company are directly owned United States government obligations." As a result, the Revenue Ruling allows for the imposition of the Nebraska state income tax on distributions representing the Plaintiff's proportionate share of interest on directly owned United States government obligations if they are part of a fund which cannot meet the 80% test.

12. The imposition of the Nebraska state income tax on any interest derived from United States obligations, regardless of the relative amount involved, is a violation of 31 U.S.C. § 3124 (a) and the Supremacy Clause of the United States Constitution.

IT IS THEREFORE ORDERED, ADJUDGED, AND DECREED that Revenue Ruling 22-87-4 is void and of no effect. Costs are taxed to the Defendant.

DATED this 19th day of November, 1990.

BY THE COURT:

/s/ Donald E. Endacott
Donald E. Endacott,
District Judge

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

JOHN LOEWENSTEIN, Plaintiff, vs. STATE OF NEBRASKA DEPARTMENT OF REVENUE, Defendant.	) Docket 428 Page 177 JOINT MOTION AND ORDER AMENDING PLEADINGS TO CONFORM TO THE PROOF (Filed Feb. 14, 1991)

The parties jointly move the court for an order pursuant to Neb. Rev. Stat. § 25-852 (1989) conforming the pleadings to the issues actually tried by allowing an amendment instanter by rider to the plaintiff's Petition as follows:

12A. On January 26, 1985, Donna Karnes, then State Tax Commissioner, issued Revenue Ruling 22-85-1. This ruling states:

> The interest income received from repurchase agreements involving obligations of the United States Government is income to the investor who provides the funds as a loan secured by Government securities. This interest income which is received from repurchase agreements involving obligations of the United States Government is subject to the Nebraska individual income tax. It is not to be subtracted from a taxpayer's federal taxable income on the Nebraska return.

The parties further stipulate that the prayer of the plaintiff's Petition be amended to include a request that Revenue Ruling 22-85-1 also be declared invalid.

JOHN LOEWENSTEIN, plaintiff

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Telephone: (402) 474-6900

By /s/ Terry R. Wittler
Terry R. Wittler, #15584

STATE OF NEBRASKA DEPARTMENT OF REVENUE, defendant

By DONALD STENBERG,
Attorney General

By /s/ David E. Cygan
David Edward Cygan, #18546
Assistant Attorney General
2115 State Capitol
Lincoln, Nebraska 68509-4906

ORDER

IT IS SO ORDERED this 14th day of February, 1991.

BY THE COURT:

/s/ Donald Endacott
Donald Endacott
District Court Judge

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

JOHN LOEWENSTEIN, Plaintiff, vs. STATE OF NEBRASKA DEPARTMENT OF REVENUE, Defendant.	) Docket 428 Page 177 ORDER AMENDING "FINDINGS OF FACT AND CONCLUSIONS OF LAW" AND OVERRULING DEFENDANT'S MOTION FOR NEW TRIAL (Filed Feb. 14, 1991)

This matter came before the court upon the parties' "Joint Motion Amending Pleadings to Conform to the Proof" and upon the defendant's Motion for New Trial. The court has sustained the Joint Motion. Accordingly, the court's "Findings of Fact and Conclusions of Law" are amended by adding the following finding of fact:

22A. On January 26, 1985, Donna Karnes, then State Tax Commissioner, issued Revenue Ruling 22-85-1. This ruling states:

> The interest income received from repurchase agreements involving obligations of the United States Government is income to the investor who provides the funds as a loan secured by Government securities. This interest income which is received from repurchase agreements involving obligations of the United States Government is subject to the Nebraska individual income tax. It is not to be subtracted from a

taxpayer's federal taxable income on the Nebraska return.

The court's findings are further amended by adding the following conclusions of law:

7A. Rev. Rul. 22-85-1 purports to limit the availability of this exemption to obligations which are not the subject of repurchase agreements.

9A. The limitation contained in Revenue Ruling 22-85-1 purporting to limit the exemption of taxation of interest from federal obligations to obligations which are not the subject of repurchase agreements violates 31 U.S.C. § 3124 and the Supremacy Clause of the U. S. Constitution.

Finally, the last paragraph of the court's Order of November 19, 1990 is amended to read as follows:

IT IS THEREFORE ORDERED, ADJUDGED, AND DECREED that Revenue Rulings 22-85-1 and 22-87-4 are void and of no effect. Costs are taxed to the defendant.

Defendant's Motion for New Trial is denied.

DATED this 14th day of February, 1991.

BY THE COURT:

/s/ Donald E. Endacott
Donald Endacott
District Court Judge

PREPARED BY:

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APPROVED AS TO FORM ONLY:

DONALD STENBERG,
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IN THE DISTRICT COURT OF
LANCASTER COUNTY, NEBRASKA

JOHN LOWENSTEIN, Plaintiff, vs. STATE OF NEBRASKA, DEPARTMENT OF REVENUE, Defendant.	)	Docket 428 Page 177 FIRST STIPULATION OF THE PARTIES (Exhibit No. 1 Received July 23, 1990)

COMES NOW the parties, by and through their undersigned attorneys, and hereby stiuplates [sic] to this court that the depositions of Stewart Brown and Peter Sternlight taken in the proceeding *Page v. Department of Revenue, State of Florida,* in the Circuit Court of the 9th Judicial Circuit for Orange County, Florida, or true copies thereof, will be submitted into evidence in the above captioned proceeding without objection from the parties.

Respectfully submitted,

BY ROBERT M. SPIRE, #13977
Attorney General

BY /s/ David Edward Cygan
David Edward Cygan, #18546
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For the Parties.

32-176-13

IN THE CIRCUIT COURT OF THE NINTH JUDICIAL CIRCUIT, IN AND FOR ORANGE COUNTY, FLORIDA

CASE NO.: CI 87-2586

JAMES F. PAGE and
ELIZABETH K. PAGE,

Plaintiffs,

vs.

DEPARTMENT OF REVENUE,
STATE OF FLORIDA,

Defendant.

****

TELEPHONIC
DEPOSITION OF: PETER D. STERNLIGHT

DATE: Wednesday, December 2, 1987

TIME: 9:31 o'clock, a.m.

PLACE: GRAY, HARRIS & ROBINSON, PA
Suite 1200
205 East Pine Street
Orlando, Florida 32801

REPORTED BY: Abby L. McClain, Court
Reporter and Notary Public

****

APPEARANCES:

GRAY, HARRIS & ROBINSON, P.A.
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Suite 1200
Orlando, Florida 32801
Attorney for the Plaintiffs

BY: JAMES F. PAGE, JR., ESQUIRE
CHARLES SELL, ESQUIRE
and
EUGUENE F. MALONEY, ESQUIRE
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Co-Counsel for the Plaintiffs

APPEARANCES CONTINUED:

DANIEL C. BROWN, ESQUIRE
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Department of Legal Affairs
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Attorneys for the Defendant

DON N. RINGSMUTH, ESQUIRE
Federal Reserve Bank of New York
Legal Department
New York, New York
Attorney for the Deponent

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Transcript of Proceedings

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[p. 3] WHEREUPON:

The following proceedings were held:

PETER D. STERNLIGHT

the Witness herein, after having first been duly sworn by the Court Reporter, testified and was examined under his oath as follows:

DIRECT EXAMINATION

BY MR. PAGE:

Q. State your name for the record, please, sir.

A. Peter D. Sternlight, S-t-e-r-n-l-i-g-h-t.

Q. Where are you employed, Mr. Sternlight?

A. The Federal Reserve Bank of New York.

Q. How long have you been employed there?

A. Since 1950.

Q. 19–

A. Five oh, since 1950, with some time out for military service and a period when I was working for the Treasury Department in Washington.

Q. All right. And what is your current function at the Federal Reserve Bank of New York, sir?

A. I'm manager of the Federal Reserve System Open Market Account for Domestic Operations, and also, I'm an Executive Vice-President at the Federal Reserve Bank.

Q. All right. What is your training, sir?

A. I have academic training as an economist. I have [p. 4] an M.A. and Ph.D. from Harvard in Economics, and I've worked at the Federal Reserve Bank during my professional career except, as I mentioned, I was for two years at the Treasury Department in 1965 to '67. I was Deputy under the Secretary for Monetary Affairs.

Q. All right, sir. Did you have occasion to give an affidavit in the case of Bevil, Bresler & Schulman Asset Management Corporation that was pending in the United States District Court for the District of New Jersey, it's Civil Case Number 85-1728?

A. Yes, I did.

Q. And do you happen to have a copy of that affidavit in front of you, Mr. Sternlight?

A. I do.

Q. Were you under oath at the time that you signed this affidavit, sir?

A. Yes.

Q. Would your – does the affidavit reflect your current opinion as to how repurchase agreements should be categorized?

A. I would say so, yes.

Q. If you were to make a similar affidavit at this time along similar subject lines, would your testimony be any different, or would your affidavit be any different than would be contained in the affidavit before you?

[p. 5] A. Not in substance, but there would be some updating of some of the statistics in there, but the essential points made would be the same.

Q. All right, sir. And is the affidavit in front of you a five-page affidavit?

A. Yes, it is.

Q. And is it dated April 11, 1986?

A. Yes, that's correct.

MR. PAGE: That's all the questions I have, sir.

I'd like to attach a copy of the affidavit to the deposition.

Go ahead with your Cross-Examination, Mr. Brown, please.

CROSS-EXAMINATION

BY MR. BROWN:

Q. Hello, Mr. Sternlight. How are you this morning?

A. Just fine, thanks, Mr. Brown.

Q. Mr. Sternlight, are you at all versed or have a degree in law from any university?

A. No, I do not.

Q. Now, you are with the Federal Reserve Bank in New York, as I understood your testimony?

A. That's right.

Q. Now, I understand that part of the function of the Federal Reserve Bank in New York and the Federal Reserve [p. 6] System as a whole is to control the money supply in this country; is that right?

A. That's correct, yes.

Q. And that you control the money supply in large part by purchasing and selling United States Government Securities to banks; is that true?

A. To purchase and sell securities to dealers in the market, some of which are banks, yes.

Q. All right, sir. And is the substance of what I just said to you correct?

A. Yes.

Q. Is that your major function, major way you control the money supply, to buy and sell United States Government Securities?

A. Yes, essentially.

Q. Okay. Now, as I understand your affidavit that you're referring to, there are short-term and quick adjustments that sometimes need to be made in the nation's money supply; is that right?

A. There are short-term adjustments in the reserves available in the banking system. That's the means

through which we influence growth with the money supplies by affecting the availability of bank reserves.

Q. All right. In any event, directly or indirectly, you've got to make changes in the reserves sometimes on a [p. 7] short-term and quick basis; is that true?

A. True.

Q. Would you say that's a function of the Federal Reserve System?

A. I would say so, yes.

Q. Now, it would be much more difficult to make those short-term modifications to reserves, would it not, if you were not able to use repurchase agreements to make those short-term adjustments?

A. I believe that is correct, yes.

Q. It is true, then, that it is in the interest of the Fed, the Federal Reserve System, to have repos, resale repurchase agreements characterized in such a manner that the Fed can continue to use them?

A. I think that's fair to say, yes.

Q. And isn't it true that if these agreements were not characterized as United States Government obligations, the Federal Reserve System would be preluded statutorily from engaging in such transactions?

A. I don't think the transactions have to be characterized as Government obligations, to my mind. I'm not speaking as a lawyer, you understand. It's the – we regard these – what we're doing is purchases and sales of

U.S. Treasury obligations, I wouldn't say that the transaction itself is a U.S. obligation.

[p. 8] Q. Let me ask the question differently.

If it were found consistently that these transactions which you characterize as purchase and resale transactions were found to be in essence secured to collateralized loans from the buyer to the seller, isn't it true that the Fed would not be allowed by law to engage in such transactions?

A. From what our Counsel tells us, we would have difficulty finding our way to do that, if they were regarded as loans.

Q. All right.

Now, putting aside the regulatory inhibitions that every government or quasi government agency has to deal with, and putting aside the legal niceties and technicalities of how these transactions are generally structured, would you agree as an economist that it's fair to say the economic substance of a transaction, what happens in the mind of an economist or financial analyst is really a collateralized credit agreement between the buyer and seller?

A. From a standpoint of its economic function, I would say it's very close to a collateralized loan, yes.

Q. All right. Now, sir, have you seen any of the – have you seen what's known as a general or master repurchase and sale agreement that is used by this particular trust [p. 9] fund that we're talking about here today? And that's the trust for short-term United States Government Securities. Have you been supplied a copy of that?

A. No, I have not seen that.

Q. And have you seen any of the terms of such a contract that is used by this particular fund?

A. Not – it wasn't presented to me as being used by that fund. I have glanced at some general repurchase agreements, contracts, and maybe they're similar to that particular one, but certainly it was not in connection with anything related to that particular entity.

Q. Has Mr. Page, who questioned you earlier, supplied you with such a document in the last day or two?

A. No.

Q. Are you familiar, sir, with the treatment that the income from repo agreements, sales, repurchase agreements of Government Securities, receives under the Federal Income Tax Code?

A. I cannot say I have an expert familiarity with that, no.

MR. BROWN: Okay, I have no further questions.

MR. PAGE: Okay.

MR. MALONEY: I have one question I would like to ask him.

(Continued on Page 10)

[p. 10] CROSS-EXAMINATION

BY MR. MALONEY:

Q. Mr. Sternlight, this is Eugene Maloney from Federal Investors. I have a follow-up question on a point I

think you were alluding to in your earlier discussion with Mr. Brown.

Would it be fair to characterize –

MR. BROWN: I'll object to the form of this question. He's your witness and you're leading him, but outside of that –

MR. PAGE: Okay.

BY MR. MALONEY:

Q. Was the point you were attempting to make in your earlier response to Mr. Brown's question that a repurchase agreement is essentially a transaction, but the result of the transaction constitutes, in your opinion, either the purchase or sale of a U.S. Government Security; i.e., can you distinguish the transaction itself from the actual result of the transaction?

A. I'm trying to weigh that question, sir. I'm not really sure I understand it clearly enough.

Q. Well, in your opinion, is the result of a repurchase agreement transaction the purchase or sale of a U.S. Government Security?

A. Yes, I would say that if the repurchase [p. 11] transaction is comprised of sales and purchases of U.S. Government Securities, if it's done in U.S. Government Securities, they can be in other instruments, of course.

MR. MALONEY: Okay.

MR. BROWN: I do have one other question, if you'll indulge me.

MR. PAGE: All right.

FURTHER CROSS-EXAMINATION

BY MR. BROWN:

Q. Mr. Sternlight, I did miss one question I was asking before.

MR. RINGSMUTH: Who's speaking, please?

THE WITNESS: Mr. Brown.

MR. BROWN: Yes, Mr. Brown.

BY MR. BROWN:

Q. I presume the Federal Reserve Bank itself at times becomes involved as a buyer in this sale, repurchase transaction that you're testifying about.

A. Yes.

Q. And when you do, do you require a margin of your seller?

A. We, in effect, do because we've –

Q. You require a haircut?

A. No, we take a haircut in the valuing.

Q. Would you explain for the record, please, what a [p. 12] haircut is?

A. Well, if we were doing a – a one million dollar transaction, we would purchase – we would make sure that we were purchasing securities. Before we spent our million dollars, we would want to be sure that we were

purchasing securities that were worth slightly more than that one million dollars that we would take in and hold.

Q. So if a security that you were thinking about purchasing had a value of one million dollars, you would pay less than one million dollars for it; is that correct?

A. Yes.

Q. And you would do that to – in essence, to protect yourself from market fluctuations in the value of that security while you held it; is that correct?

A. That is true.

Q. And you require interest upon the repurchase price; do you not?

A. Yes.

MR. BROWN: I have nothing further. Thank you.

MR. PAGE: Mr. Sternlight, I have just a few questions.

MR. RINGSMUTH: Would the questioner identify himself, please?

MR. PAGE: Yes, sir, this is Mr. Page again.

(Continued on Page 13)

[p. 13] REDIRECT EXAMINATION

BY MR. PAGE:

Q. You do business with certain companies that are on an approved list, I presume, for repurchase agreements; is that correct?

A. That's right.

Q. Does the Fed seek out financial information about the solvency of those companies?

A. Yes. We get reports from them on their activity, including balance sheet information.

Q. And the Fed would have certain rights under their repurchase agreements in the event of a default by one of those repurchase sellers; would they not?

A. Yes.

Q. Are you generally familiar with the terms of repurchase agreements as are used in the U.S. Government Securities market?

A. Well, I think generally familiar, not as a legal expert.

Q. Okay. Does the Fed have such an agreement that it uses typically, or do you use the agreements from the various companies you do business with?

A. Oh, we have our own agreement that we use with our counterparties.

Q. And how many page document is that; do you have [p. 14] any idea?

A. I don't remember offhand, sir.

Q. Would that be something that would be available that we could have Faxed to us today?

A. Yes, I think so.

Q. All right. I would ask that you, you or Mr. Ringsmuth, if you can conveniently do so, Fax one to us, and I would like to attach it to this deposition when I receive it.

A. We'll do that, surely.

MR. BROWN: That is not without objection on my part –

MR. PAGE: I understand.

MR. BROWN: – but I want you to understand that.

MR. PAGE: I understand.

BY MR. PAGE:

Q. And do you have – by chance a copy of that in you office right there available to you now, sir?

A. I do not, no.

MR. PAGE: Okay. That's all the questions I have at this time.

Mr. Sternlight, you have the right to read and sign this deposition when it's transcribed, which it's going to be here in the next hour, or you can waive your right and depend on the accuracy of the Court [p. 15] Reporter. We would hope that you would waive that right so that we could use this deposition at the trial in this case this afternoon, but you have that right, sir, to exercise one way or the other.

THE WITNESS: No.

MR. RINGSMUTH: He has no objection to that, but we do ask that you transmit by Facsimile the transcribed transcript when it's available.

MR. PAGE: We'll be happy to do that. Thank you very much.

THE WITNESS: All right.

MR. PAGE: We appreciate your help and cooperation.

STIPULATIONS: It is hereby stipulated and agreed to by and between Counsel for the respective parties and the Deponent, that the reading and signing of this deposition be waived.

(Whereupon, subsequent to the close of the deposition, the document was marked as Plaintiffs' Exhibit Number 1) (Whereupon, this deposition was concluded at 9:56 o'clock, a.m.).

[p. 16] CERTIFICATE

STATE OF FLORIDA :

COUNTY OF ORANGE :

I, ABBY L. McCLAIN, being a Stenotype Shorthand Reporter and Notary Public, State of Florida at Large, do hereby certify that I did, at the time and place herein designated, place under oath the Deponent, PETER D. STERNLIGHT, who was thereupon examined; that said examination was recorded, by me, in Stenotype notes which were later reduced, by me, through computer-aided transcription, to typewritten form; and that the foregoing pages, numbered 3 through 15, inclusive, constitute a true, complete and accurate transcription of my said Stenotype notes taken therein.

I further certify that I am neither of counsel nor related to any party involved in this action, nor am I financially interested in the outcome of this case.

WITNESS MY HAND AND OFFICIAL SEAL, on this, the 2nd day of December, 1987, in the City of Orlando, County of Orange, State of Florida.

ABBY L. McCLAIN
Court Reporter
Notary Public

My Commission Expires:
March 4, 1991

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

In the Matter of: BEVILL, BRESLER & SCHULMAN ASSET MANAGEMENT CORPORATION, Debtor.	(Hon. Dickinson R. Debevoise) Civ. No. 85-1728 Chapter 11
SAUL S. COHEN, Trustee of Bevill, Bresler & Schulman Asset Management Corporation, Plaintiff, vs. ARMY MORAL SUPPORT FUND, et al., Defendants.	Adversary Proceeding No. 85-2103
In re: BEVILL, BRESLER & SCHULMAN, INC., Debtor.	Civ. No. 85-2224
RICHARD W. HILL, Trustee for the liquidation of Bevill, Bresler & Schulman, Inc., Plaintiff, vs. FIDELITY NEW YORK, F.A., et al., Defendants.	Adversary Proceeding No. 85-5274

STATE OF NEW YORK)
) ss:
COUNTY OF NEW YORK)

AFFIDAVIT OF PETER D. STERNLIGHT

1. I am Executive Vice President of the Federal Reserve Bank of New York ("FRBNY") with responsibility for the Open Market Operations Function.

2. I have had experience at the FRBNY's open market trading desk since the 1960's, and for the past six years I have been Manager of the System Open Market Account ("SOMA"). In that capacity, I have responsibility for a variety of types of transactions undertaken by the FRBNY open market desk for the account of SOMA. The object of those transactions is to adjust the level of bank reserves in order to achieve the Federal Open Market Committee's monetary policy goals. FRBNY also carries out transactions in the market on behalf of foreign central banks to aid them in their dollar investments.

3. Repurchase agreements involving United States Treasury issues and certain other agency issues are essential to the operations of the open market desk for reserve adjustments. In addition, the liquidity and flexibility provided by repurchase agreements are essential to the efficient functioning of the government securities markets. Repurchase agreements are unique vehicles for short-term, high-volume financing. As used in the market today, repurchase agreements are viewed generally as contracts for the sale of securities and their resale back to the original seller at a future date. An essential feature of this arrangement is that securities delivered under a

repurchase agreement are freely transferable and unencumbered by restriction from previous transfers.

4. During 1985, the FRBNY conducted SOMA transactions in the market in the aggregate amount of $212 billion. Of these, 74 percent were repurchase transactions, and 17 percent were reverse repurchase transactions (known to FRBNY as matched sale-purchase agreements). Thus, only 9 percent of the 1985 SOMA market transactions conducted by the FRBNY were conducted without the use of repurchase or reverse repurchase agreements. Also during 1985, the FRBNY conducted $188 billion worth of transactions in the market on behalf of approximately 150 foreign central banks and other foreign official institutions. Of these, some 62 percent were repurchase transactions. Federal Reserve operations in the market on a single day through repos or reverse repos often come to $3-4 billion and have reached as high as 7.9 billion.

5. The FRBNY repurchase transactions are, by statute, structured and conducted as contracts for purchase-and-sale. The high volume of Federal Reserve open market operations requires the broadest possible repurchase market for government securities. It is doubtful that the FRBNY would have access to a market for repurchase agreements characterized as secured loans. Such a result could impair the FRBNY's ability to maintain appropriate levels of bank reserves from week to week, diminish the FRBNY's ability to achieve reserve growth objectives, and possibly accentuate interest rate volatility.

6. Repurchase agreements are an important method for dealer financing of their inventories of United States

government securities. The primary dealers typically underwrite a sizeable [sic] portion of new Treasury issues – 35-75 percent – and rely heavily on temporary financing through repurchase agreements pending resale of the issues to other investors. Clearly, an impairment of the repo market would make it less attractive for dealers to perform this very useful underwriting function, thus adding to Treasury interest costs.

7. Repurchase agreements are a major vehicle in the market-making process, providing the means for creating hedges and arbitrages among various issues and thereby increasing liquidity. Through these transactions, the dealer market adds to the close substitutability among Treasury issues, enhancing the attractiveness of the market for a variety of participants, which in turn increases the market for Treasury issues. If repurchase agreements were to lose their present characteristics of flexibility and liquidity, the dealer market – a critical element in the process of financing the national debt through Treasury issues – would be handicapped. More generally, a hobbling of the repo market could have broad rate effects throughout the financial markets, diminishing efficiency and the allocation of resources. Market participants would turn to less liquid forms of investment that would tend to produce higher rates in the economy at large. Greater volatility of rates as a consequence of a diminished repo market could add to average rate levels.

8. Repurchase agreements have proven to be invaluable to a wide variety of institutional investors, both public and private. A significant number of participants in the market are public entities who face constitutional, statutory, or regulatory restrictions on lending and

borrowing activities, but can and do rely on repurchase agreements to achieve investment, cash management and liquidity needs. If repurchase agreements, with their present characteristics (including unencumbered transferability of securities delivered under repo contract), and in their present form and as presently understood in the market (contracts for the sale and repurchase of securities) were unavailable to these participants in the market, the more costly financing alternatives would have adverse consequences for the entities involved, and their withdrawal from the government securities market as repurchase participants would adversely impact the market.

9. Repurchase agreements, as used and understood by the FRBNY in conformity with recognized and accepted market practice, are agreements for the transfer of securities with a simultaneously executed agreement to retransfer securities back to the original seller at a specified future date. They are structured and treated as sales and repurchases, unencumbered by any restriction from prior transfer that would impede further transfer. This treatment is essential to the purposes for which repurchase agreements are employed: high-volume, short-term financing transactions.

/s/ Peter D. Sternlight
Peter D. Sternlight

Subscribed and sworn
to before me this 11th
day of April, 1986

/s/ Margaret M. Manuel
Notary Public

MARGARET M. MANUEL
Notary Public, State of New York
No. 30-4825241
Qualified in Nassau County
Certificate filed in New York County
Commission Expires May 31, 1989

IN THE CIRCUIT COURT OF THE NINTH JUDICIAL CIRCUIT, IN AND FOR ORANGE COUNTY, FLORIDA

CASE NO: CI 87-2586

JAMES F. PAGE and
ELIZABETH K. PAGE,

Plaintiffs,

COPY

vs.

DEPARTMENT OF REVENUE,
STATE OF FLORIDA,

Defendant.

****

DEPOSITION OF:	STEWART BROWN
DATE:	Wednesday, December 2, 1987
TIME:	10:10 o'clock, a.m.
PLACE:	GRAY, HARRIS & ROBINSON, PA Suite 1200 205 East Pine Street Orlando, Florida 32801
REPORTED BY:	Abby L. McClain, Court Reporter and Notary Public

****

APPEARANCES:

GRAY, HARRIS & ROBINSON, P.A.
205 East Pine Street
Suite 1200
Orlando, Florida 32801
Attorney for the Plaintiffs

BY: JAMES F. PAGE, JR., ESQUIRE
CHARLES SELL, ESQUIRE
and
EUGENE F. MALONEY, ESQUIRE
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Tallahassee, Florida 32301
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TESTIMONY OF STEWART BROWN:

Direct Examination by Mr. Page 3

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* * *

[p. 3] WHEREUPON:

The following proceedings were held:

STEWART BROWN,

the Witness herein, after having first been duly sworn by the Court Reporter, testified and was examined under his oath as follows:

DIRECT EXAMINATION

BY MR. PAGE:

Q. State your name for the record, please.

A. Stewart L. Brown.

Q. Okay. And where are you employed, Mr. Brown?

A. I work at Florida State University.

Q. Okay, in what capacity?

A. Associate Professor Finance.

Q. And what is your background and training educational-wise?

A. I have a B.S. and M.B.A. and Ph.D. in Finance from the University of Florida. The Ph.D. I got in December of '74.

Q. Okay. And what have you done vocationally since you graduated from the University of Florida?

A. I taught at Florida State University.

Q. And what courses do you teach at F.S.U.?

A. I teach finance courses, and I teach money capital markets, bank management, investments at the undergraduate, [p. 4] graduate and advanced graduate level. I've taught in options and commodities. In general, I teach in the area of investments and money and capital markets.

Q. You do any consulting?

A. Yes.

Q. What types?

A. I have had a relationship with the State Board of Administration since September of '83. The State Board is the State Pension Fund, currently about thirteen billion dollars. And I also do expert witness work in the securities area.

Q. And what is your relationship with the State Board of Administration?

A. I am a paid consultant. I am on an annual retainer with them.

Q. What do you consult on; types of investments they should make?

A. In general, I bring the academic perspective to the Board. I sit in on presentations from people from Wall Street. And the way you characterized it is correct. I consult on various investment opportunities that they have.

Q. Okay. And I presume you were contacted in this case just shortly ago.

A. Yes, sir.

Q. What have you reviewed in preparation for your [p. 5] testimony here today or at trial?

A. I have reviewed various documents from the mutual fund, I don't know how to characterize them, their prospectus. There's a master repo agreement, there's a – an example repo transaction. I've also done a – I went to the library and did a literature search on repos, and I went through the – what had been written by Marsha Stigum in The Money Market.

Q. Who is Marsha Stigum?

A. Marsha Stigum –

Q. How do you spell that?

A. S-t-i-g-u-m – is a Ph.D. economist who has written a book called The Money Market, I have the revised edition, and it's more or less the Bible of money market transactions.

I also reviewed my notes from courses I teach to refresh myself, and glance through various investment textbooks.

Q. Okay. And what did your literary research reveal?

A. Not much. A couple of articles that were written after the – basically the two articles I found came from accounting journals that were written basically after the ESM debacle down in Fort Lauderdale, educating accountants on what to look for and understanding repo transactions, since a good part of the ESM problem did involve some fraud [p. 6] on the part of a C.P.A. firm. So it didn't reveal anything that I didn't know aside from a few details.

Q. Are you proposing to offer any of these articles as evidence in your testimony this afternoon?

A. No.

Q. So you looked at the two articles regarding the accountant and repo agreements plus Marsha Stigum's article or book?

A. Yes, and glanced through some textbooks.

Q. Okay. What opinions are you prepared to offer today?

A. The essence of the opinion is that the economic substance of a repo transaction, if you look through the legalities of what is really going on, is a collateralized loan between a lender and borrower.

Q. Okay. Have you reviewed any law – cases in preparation for your testimony?

A. I did glance at one, and I can't remember the name of it. It was the one involving the State of Florida. Gibney (ph) comes to mind.

Q. Gilmore?

A. Gilmore. Gilmore versus the State of Florida.

Q. And in that situation, the Court found that it was not a collateralized loan, it was a purchase and sales transaction; is that correct?

[p. 7] A. That's my understanding, yes, sir.

Q. And do you have any problem with the decision of the Court in that case?

A. Well, like I said, I just glanced at it. My understanding of it is that there was – that the case turned. Again, I'm not an attorney and I have only the vaguest notion, but the case turned on a point of contract law on whether indeed there was an agreement to resell. And it – I may not be characterizing it right, but the essence I got out of it, that that case is substantially different from this case, since in this case, in looking at the repo, the agreement, there is – there's a lot of difference, is the essence of what I came away from it with.

Q. Okay. And have you analyzed the repo agreement to – that you were provided with in this case?

A. Yes, I have.

Q. All right. And is this repo agreement typical of repo agreements that are used in the U.S. Government Securities market?

A. My sense of it is, yes. And I have not reviewed a lot of repo agreements, so I don't know, but it is entirely in keeping with everything that I've read and everything that I know about the repo market.

Q. Okay. How many times have you looked at the repo issue?

[p. 8] A. This is really the first time I've looked at it in detail. I have taught about it and taught the essence of repo transactions for – well, ever since they really became widely used in the late seventies, but this is the first time I have looked at the issue – specific issue of repos in depth.

Q. How would you define a repo?

A. A definition of a repo?

Q. Um-hmm.

A. Is, I would say, that a repo is a transaction, a securities market transaction between a lender and borrower that involves the legal title of transfer, that the transfer of legal title between the borrower and the lender is a means of collateralizing the loan, so the essence of the economic transaction is that a lender lends money to the borrower and protects a lien against his collateral by taking legal title to the security.

MR. MALONEY: Dr. Brown, is that the definition you would give your –

MR. BROWN: I'm sorry to make an objection. I don't mind one attorney questioning, but I don't want you double-teaming him. I think that's fair.

MR. PAGE: That's generally the way we do it here. Why don't you slip me a note.

MR. MALONEY: All right.

[p. 9] BY MR. PAGE:

Q. Had you finished your answer?

A. If I was going to define this for my students, I would say something like a repo transaction is a short-term money market transaction involving the transfer of funds from a lender to a borrower, and the transfer in the opposite direction from the securities – from the borrower to the lender to secure the loan, and the essence of the transaction is that of a collateralized loan. And I would say something very like that in a classroom.

Q. And how is that – is the security interest in the collateralized loan perfected? Do you have any knowledge of that?

A. No, I'm not an attorney. My sense of it is, some form of title does pass and that's the legal artifact in doing the transaction.

Q. Is there a promissory note executed in connection with the –

A. Typically not.

Q. – transaction?

A. Typically not, is my understanding.

If there was these general agreements that – and again, I'm not an attorney, so I don't know how to characterize it.

Q. You heard Dr. Sternlight's deposition.

[p. 10] A. Yes.

Q. He characterizes the repo agreement as a purchase and sale. Do you –

A. I don't agree with that. I think he said the essence of it economically is that it's a collateralized loan. I heard him say that very definitely.

Q. He also said, I think he said it in his affidavit, that he characterizes such transactions as purchases and sales. Do you disagree with that?

A. No, I don't disagree that there is a sale and a repurchase, that there is some sort of legal title to the securities in the nature given the – in the transaction. The nature of those securities gets changed, that the holder of the purchase – of the security doesn't get to keep the interest on them, that there is – that there's margin against the security.

In essence, the parties in the transaction are acting like lenders and borrowers rather than one selling the – if somebody wanted to buy a security, they could buy it outright in the securities market, they don't need to do it under a repo.

Q. Do you understand what the definition, the Federal Reserve Board definition of a repurchase agreement is?

A. No.

Q. Okay. Is this your Curriculum Vitae?

[p. 11] A. Yes, it is.

MR. BROWN: Yes, it is.

Would you like to make a copy of it and have it attached?

BY MR. PAGE:

Q. Are you aware that the Federal Reserve Bank of Richmond has published a definition of a repurchase agreement as the actual purchase and sale of a U.S. Government Security?

A. No, I was not aware of that.

Q. Would you – if, in fact, you were confronted with that, how would you respond to that?

A. I would respond a couple ways. I would respond that the Federal Reserve Bank of Richmond has a vested interest in defining a repo that way, for reasons that were articulated in the earlier deposition.

Q. Um-hmm.

A. The way the Fed operates is made much easier if they can call this thing a sale and repurchase and not a collateralized loan.

My second response would be that you can legally define something in a particular way. And I'm not an

attorney, but if you look through the economic essence of this transaction, it's clearly a collateralized loan.

Q. Okay. If it's in the interest of the Fed to [p. 12] define it that way, would it be in the interest of the country as a whole to define it that way?

A. Strictly from a monetary perspective, I believe so. I can't say about the interest of everybody, taking everything into account.

From conducting a monetary policy, it's clearly made easier if the Fed can operate in the repo market.

Q. And the repo market is the way the national debt is financed; is it not?

A. No. No.

The repo market – the big players in the repo market are the thirty-six primary U.S. Government Securities deals. Of course, there are secondary dealers and boutiques, if you will, and they basically are in the business of making a market of U.S. Government Securities. But at any one point in time, and I don't know the exact numbers, but I suspect that the U.S. Government dealers hold a relatively small proportion of the total debt outstanding, the rest is out in the hands of mutual funds and banks and pension funds and the like.

Q. Have you ever reviewed the case of Bevill, Bresler & Schulman?

A. No, I have not.

Q. So basically, if I understand what you're saying, Dr. Brown, you're not trying to give a legal definition of

[p. 13] repurchase agreement, you're trying to give a definition from an economics standpoint?

A. That's correct.

Q. Would you explain your understanding of how the Fed uses the repo market?

A. Sure. The job of the Federal Reserve is to control the money supply of the country, typically defined as coin currencies and demand deposits. Demand deposits are checking accounts of the banking system.

The way that the Federal Reserve controls the money supply is by controlling the reserves of the banking system, defined as vault cash and deposits at the bank.

Q. Defined as what?

A. Vault cash and demand deposits at the Fed. Usually done through deposits at the Fed, although in magnitude the two are about the same.

The deposit at the Fed, the banks keep – comes away being their reserve deposit. And the way that the Federal Reserve controls those reserve deposits is by buying and selling U.S. Government Bonds in the open market. Now, those reserve deposits are subject to day-to-day fluctuations from various causes, including float, including changes in the amount of cash that the public wants to hold, including Treasury operations, international operations.

There are any number of things that can cause bank [p. 14] reserves to change on a day-to-day basis independent of anything that the Federal Reserve does. So what the Federal Reserve attempts to do is to use what we

characterize in the classroom as defensive open market operations. They offset these day-to-day fluctuations in reserves from independent factors by buying and selling U.S. Government Bonds on a short-term basis. Sometimes on a short-term basis is one day or even a few hours. The – it becomes – is greased, if you will. The system works best when the Fed is able to do so using repos.

For instance, let's suppose that reserves – for some reason there is a snow storm over the Rockies and we have trouble getting checks from the East Coast to the West Coast, so that float increases and bank reserves are going to increase. It's known that bank reserves are increasing on a very short-term basis, two or three days.

What the Federal Reserve can do, go in and do two or three repos and the transaction automatically reverses itself two or three days later. So the Fed's ability to conduct monetary policy is enhanced by using the repo market.

Q. Are you familiar with Mr. Sternlight?

A. I don't know him personally. I mean, I know that – he's a heavy hitter.

Q. Um-hmm. Is his job a very sensitive job?

[p. 15] A. Surely.

Q. In the Federal Reserve Bank of New York, where would he be placed; in the top two or three guys?

A. Very clearly.

Q. Was the Federal Reserve Bank of New York heavily involved in bailing out the stock market after the October 19th crash?

A. My understanding, it was, yes.

Q. How did that happen; do you know?

A. The crash or the bail-out?

Q. No, the bail-out.

A. Sure. In essence, what they did, they increased bank reserves and put the liquidity out there in the financial system.

Q. If they had not done that, what would have happened?

A. I don't know. It wouldn't have been pleasant.

MR. PAGES: Do you have a copy of that affidavit that I gave you there from Sternlight?

(Discussion held off the record)

BY MR. PAGE:

Q. If the Fed was not able to use repurchase agreements freely, what would happen to their operations?

A. Nothing, be a little more inconvenient to the open market operations, but they can do it just as well in the [p. 16] Treasury Bill market as in the repo market.

Probably just as well is probably too strong a statement. My understanding and my belief is that they could operate essentially like they've always operated.

Q. So if Mr. Sternlight says that they need repurchase agreements, to retreat [sic] these purchase and sale agreements to operate in the manner they have been, you would disagree with that?

A. I mean, your characterization in the manner in which they have been, clearly they would have to change their procedures a little bit.

I think – I'm very confident if you ask Mr. Sternlight if they could still conduct open market operations in essentially the same way and have the same impact as they do now without repo agreements, he'd tell you, yes, they'd manage fine. They'd have to change their procedures a little bit, but, you know, the system is not going to come apart if the Federal Reserve can't use repo transactions. I'm absolutely confident in making that sort of statement.

MR. PAGE: Okay. Eugene, you got anything else?

MR. MALONEY: (Counsel shakes head)

MR. PAGE: Okay. That's all the questions I have at this point.

MR. BROWN: No questions.

[p. 17] MR. PAGE: Stewart, you want to waive reading and signing, or do you want to have it looked at?

MR. BROWN: Up to you.

THE WITNESS: No.

STIPULATIONS: It is hereby stipulated and agreed to by and between Counsel for the respective parties and the Deponent, that the reading and signing of this deposition be waived.

(Whereupon, this deposition was concluded at 10:36 o'clock, a.m.)

[p. 18] CERTIFICATE

STATE OF FLORIDA :
:
COUNTY OF ORANGE :

I, ABBY L. McCLAIN, being a Stenotype Shorthand Reporter and Notary Public, State of Florida at Large, do hereby certify that I did, at the time and place herein designated, place under oath the Deponent, STEWART BROWN, who was thereupon examined; that said examination was recorded, by me, in Stenotype notes which were later reduced, by me, through computer-aided transcription, to typewritten form; and that the foregoing pages, numbered 3 through 17, inclusive, constitute a true, complete and accurate transcription of my said Stenotype notes taken therein.

I further certify that I am neither of counsel nor related to any party involved in this action, nor am I financially interested in the outcome of this case.

WITNESS MY HAND AND OFFICIAL SEAL, on this, the 2nd day of December, 1987, in the City of Orlando, County of Orange, State of Florida.

/s/ Abby L. McClain
ABBY L. McCLAIN
Court Reporter
Notary Public

My Commission Expires:

March 4, 1991

IN THE DISTRICT COURT OF
LANCASTER COUNTY, NEBRASKA

JOHN LOEWENSTEIN, Plaintiff, vs. STATE OF NEBRASKA, DEPARTMENT OF REVENUE, Defendant.	) Docket 428 Page 177))))))))	SECOND STIPULATION OF THE PARTIES (Exhibit No. 2 Received July 23, 1990)

The parties hereby stipulate that solely for the purposes of this action the following paragraphs shall be taken as true.

1. The Trust for Short-Term U.S. Government Securities and the Trust for U.S. Treasury obligations (the "Trusts") are no-load, open-end, diversified investment companies whose primary objective is to receive current income from ownership of U.S. Government securities and obligations, either directly or through the use of repurchase agreements.

2. The Trusts do not engage in any other business.

3. The Trusts are qualified as regulated investment companies under Internal Revenue Code Subchapter M and are established under the Investment Company Act of 1940.

4. The Trusts are what is commonly known as "mutual funds."

5. The Trusts make U.S. Government securities accessible to investors in much smaller denominations than sold in the marketplace and provide a distribution of the risk through a diversified portfolio of U.S. Government securities.

6. The Trusts invest in short-term securities and obligations of the U.S. Government and its agencies and instrumentalities either directly or through repurchase agreements. The Trusts hold no other securities.

7. The Trusts hold U.S. Government securities and Treasury obligations directly and through repurchase agreements.

8. Each of the federal securities held by the Trusts, either directly or through repurchase agreements, are "obligations of the United States . . . exempt from state income taxes under the laws of the United States" as that term is used in *Neb. Rev. Stat.* § 77-2716 (1988 Cum. Supp.).

9. A typical repurchase agreement used by the Trusts is attached hereto as *Exhibit A*.

10. A standard repurchase agreement ("repo") consists of a two-part transaction.

11. The first part consists of the transfer of specified securities by the seller to the buyer, in exchange for cash.

12. The second part consists of the contemporaneous agreement by the seller to repurchase the securities at the original sale price, plus an agreed upon amount of "interest," paid on a specified future date (the "Maturity Date").

13. Actual delivery is taken of the securities through the Federal Reserve book entry system.

14. There is no separate promissory note executed in connection with the repurchase agreement.

15. The repurchase price of the government securities subject to a repo is typically less than the market value of the securities.

16. For example, in the case of a two percent differential, the buyer will receive $1,020,000 of securities for the purchase price of $1,000,000.

17. The differential provides a margin of financial security for the buyer in case the securities decline in value and the seller fails to repurchase them.

18. The repurchase price of the securities is equal to the original sale price, plus the negotiated interest.

19. The interest paid by the seller upon repurchase is less than the interest rate accruing on the purchased securities.

20. The income earned on each share of the Trusts is each share's proportionate fractional share of the total income realized from the underlying federal securities and obligations owned by the Trusts, after deducting the administrative costs associated with the U.S. obligations.

21. The Trusts have historically distributed all of their net income to their shareholders.

22. On September 11, 1987 Donald S. Leuenberger, then State Tax Commissioner, issued Revenue Ruling 22-87-4, a copy of which is attached hereto as *Exhibit B*.

23. This Ruling requires that for tax years after 1986, dividends from regulated investment companies owning obligations of the U.S. Government must be included within taxable income for purposes of the Nebraska Individual Income Tax unless 80 percent or more of the assets of the Company for every quarter of the taxable year were directly owned U.S. Government obligations.

24. The defendant has advised taxpayers through the instructions included with the Nebraska Individual Income Tax forms for 1987 and subsequent years that repurchase agreements covering U.S. Government securities cannot be counted towards satisfying the 80 percent requirement of this Revenue Ruling.

25. At the end of each quarter of the tax year in 1987 less than 80 percent of the assets of the Trusts consisted of U.S. securities directly owned by the Trusts.

26. As a result of the foregoing Revenue Ruling, defendant maintains that plaintiff's dividends for 1987 and subsequent years received from the Trusts are subject to the Nebraska state income tax.

Dated this 23rd day of July, 1990.

JOHN LOEWENSTEIN, Plaintiff

By CLINE, WILLIAMS, WRIGHT, JOHNSON & OLDFATHER
1900 FirsTier Bank Building
Lincoln, Nebraska 68508
Telephone: (402) 474-6900

By: /s/ Terry R. Wittler
Terry R. Wittler (#15584)

Dated this 23rd day of July, 1990.

STATE OF NEBRASKA,
DEPARTMENT OF REVENUE,
Defendant

By ROBERT M. SPIRE
Attorney General

By /s/ David Edward Cygan
David Edward Cygan,
#18546
Assistant Attorney General
2115 State Capitol
Lincoln, NE 68509-4906
(402) 471-2682

EXHIBIT A

GENERAL REPURCHASE AGREEMENT

From time to time each registered investment company listed on Exhibit A to this agreement, individually but not jointly ("Fund") and ___ ("Seller") may engage in repurchase transactions whereby Seller sells to the Fund obligations issued or guaranteed by the United States Government or agencies thereof, ("Eligible Securities") at a price as may be agreed upon ("Sale Price") and having a market value at least equal to the Margin Percentage (as defined in paragraph 1 below) of the Sale Price, and whereby, on a date fixed by agreement between Seller and the Fund, or, in the absence of such agreement, upon demand by either of them, Seller agrees to repurchase such Eligible Securities from the Fund, and the Fund

agrees to resell such securities and pay over all principal, interest and other sums paid by or on behalf of the issuer in respect thereof collected by the Fund (and not previously paid over to Seller pursuant to paragraph 9 below) to Seller, at the Sale Price plus interest at the agreed upon interest rate ("Interest Rate"), all subject to and in accordance with the following terms and conditions:

1. *Payment and Delivery.* If the Fund and Seller agree to enter into a repurchase transaction, Seller shall sell to the Fund and, on the same day, transfer to the Fund's designated custodian ("Custodian") the agreed upon Eligible Securities, together with all rights related thereto and all proceeds thereof, against the crediting of the Sale Price for such transaction to an account of Seller in immediately available funds. Seller shall take, or cause to be taken, any additional actions as the Fund shall reasonably request, to perfect the Fund's interest in such securities. The "Margin Percentage" shall be 102% or such greater percentage as is agreed upon by Seller and the Fund prior to or upon entering into such transaction. All such Eligible Securities which shall at any time have been sold to Fund and delivered to Custodian and not repurchased hereunder, together with all rights related thereto and all proceeds thereof, shall hereinafter be referred to as the "Securities".

2. *Market Value.* The market value of the Securities shall on any business day be the sum of (1) the bid quotations for such Securities as reported in the immediately preceding business day's *Wall Street Journal* or any other recognized reporting service, as Fund and Seller may agree, plus (ii) the accrued interest on such Securities on the date of determination.

3. *Confirmation.* No later than the next business day following the commencement of each repurchase transaction as described in paragraph 1, Seller shall send to the Fund a confirmation, with a copy to the Custodian setting forth with respect to such repurchase transaction: the Eligible Securities subject thereto; the Sale Price of such Eligible Securities; the applicable Interest Rate; the applicable Margin Percentage; and the date, if any, fixed for termination of the transaction, or a notation that the transaction is terminable upon demand.

4. *Representations of Fund.* The Fund represents that it is duly authorized to enter into this agreement and the transactions contemplated hereby, that this agreement does not violate any ordinance, charter, rule or statute applicable to the Fund and that the person executing this agreement on behalf of the Fund is duly and properly authorized to do so.

5. *Representation of Seller.* Seller represents and warrants that it has the unqualified right to sell, transfer, assign or pledge the Eligible Securities that will become Securities and that such securities, upon delivery to the Custodian, will be free and clear of any lien, claim or encumbrance. Seller further represents that this agreement is legally entered into by Seller, does not violate any ordinance, charter, rule or statute applicable to it and that the person executing this agreement on behalf of Seller has been duly and properly authorized to do so. Seller represents that it does not exercise discretionary authority or control with respect to the investment of the assets of any employee benefit plan or render investment advice (as defined in ERISA) to any such plan, except for plans established for its own employees or those of its affiliates.

6. *Substitution.* At any time and from time to time until the Fund shall make a demand for Seller to repurchase the Securities, or until the date fixed for repurchase in case of repurchase transactions having a fixed term, Seller shall have the right, upon notice given to the Fund by telephone or otherwise no later than 10:00 A.M. New York Time, on a banking day, to repurchase Securities on that day and to substitute by sale on the same day Eligible Securities provided that the market value at the time of such substitution of such substituted securities shall not be less than the Margin Percentage of the Sale Price of the Securities for which substitution is made. Each such substitution shall be effected by the Custodian's delivering to Seller or its agent the Securities to be repurchased against the crediting of the Sale Price for such Securities to an account of the Fund in immediately available funds and by Seller delivering to the Custodian the substituted securities against the crediting of such Sale Price, also in immediately available funds, to an account designated by Seller. When delivered to Custodian such substituted securities shall be considered Securities for all purposes. Seller, upon each substitution, shall prepare and deliver to the Fund an updated schedule of the securities.

7. *Transaction Termination.* In the case of repurchase transactions terminable upon demand, such demand shall be made by the Fund or Seller by telephone or otherwise no later than 10:00 A.M. New York time on the banking day on which such repurchase will be made. On the date of such demand, or on the date fixed for termination in the case of repurchase transactions having a fixed term, termination of the repurchase transaction will be effected

by delivery to Seller or its agent of the Securities and any principal, interest and other sums paid by or on behalf of the issuer in respect thereof collected by the Fund (and not previously paid over to Seller pursuant to paragraph 9 hereof) against the crediting of the Sale Price plus Interest (as described in paragraph 8) to an account of the Fund in immediately available funds.

8. *Interest.* Interest on the Sale Price for each repurchase transaction shall be calculated on the basis of a 360-day year and actual days elapsed and shall be paid upon termination or for such other periods or at such other times as may be agreed upon by Seller and the Fund.

9. *Payments on Securities.* The Fund agrees to pay over to Seller as soon as received all principal, interest and other sums paid by or on behalf of the issuer in respect of the Securities and collected by the Fund, provided, however, that the Fund may retain any such sums as Cash Collateral if the payment to the Seller and would result in the Margin Percentage falling below 102%, unless Seller delivers Cash Collateral or Eligible Securities to the Fund sufficient to meet Seller's obligations under paragraph 10 hereof. The Fund agrees that it will not resell or reregister the Securities unless an event described in paragraph 13 shall have occurred.

10. *Margin Maintenance – Seller's Obligation.* If the market value (as determined in accordance with paragraph 2 above) of the Securities under any repurchase transaction shall at any time be less than the Margin Percentage of the Sale Price applicable to such repurchase transaction, the Fund may upon one business day's notice

to Seller require that Seller or its agent deliver to the Custodian cash ("Cash Collateral") or an additional amount of Eligible Securities from the category of such securities or from other categories acceptable to the Fund the market value of which, together with the market value of the Securities, will equal at least the Margin Percentage of the Sale Price applicable to such repurchase transaction. When delivered to the Custodian, any such additional securities shall be considered Securities for all purposes. Any deliveries of additional securities under this paragraph shall be accompanied or preceded by a statement of Seller as to the individual market values of the additional securities.

11. *Margin Maintenance – Fund's Obligation.* If the market value of the Securities plus the amount of any Cash Collateral under a repurchase transaction shall exceed the Margin Percentage of the Sale Price applicable to such repurchase transaction, Seller may upon one business day's notice to the Fund require that the Fund or its agent return to Seller or its agent that part of the Securities or amount of Cash Collateral specified for return in the market value report described below, provided that the market value of the remaining Securities, in addition to the amount of any Cash Collateral, shall be at least the Margin Percentage of the Sale Price applicable to such repurchase transaction. During the term of any repurchase transaction under this agreement Seller shall furnish to the Fund upon request or at any time upon Seller's initiative a report of the market value of the Securities and any resulting deficiency or excess under this paragraph. Cash Collateral may at any time and from time to time with respect to any repurchase transaction be

withdrawn from pledge against simultaneous delivery to the Custodian for the account of the Fund of Eligible Securities with a market value greater than or equal to the amount of Cash Collateral withdrawn, at which time such Eligible Securities shall become Securities.

12. *Seller's Financial Condition.* Seller has delivered to the Fund copies of its most recently available annual audited financial statements as well as its most recently available unaudited financial statements and shall furnish additional audited and unaudited statements of its financial condition as they are issued. Seller represents that such statement fairly represents its financial condition and net capital ratio as to the date of that statement. Seller also represents that there has been no material adverse change in its financial condition or net capital ratio since that date. Seller shall promptly deliver to the Fund all statements subsequently required to be furnished to Seller's customers by such rule. Seller agrees that its agreement to enter into each repurchase transaction shall constitute a representation that there has been no material adverse change in its financial condition since the date of the latest such statement which the Seller has not disclosed to the Fund in writing. Seller has also delivered to the Fund its most recent financial information otherwise available to the public and, as long as any repurchase transaction is outstanding under this agreement, will promptly deliver to the Fund any such financial information subsequently available.

13. *Seller Events of Default.* The occurrences of any of the following shall constitute a "Seller Event of Default":

(a) If the Sale Price is not repaid to the Fund as specified in paragraph 7;

(b) If any interest is not paid to the Fund as specified in paragraph 8, and such default is not cured within one business day after notice;

(c) If Seller shall fail to maintain the Margin Percentage as provided in paragraph 10, and such default is not cured within one business day after notice;

(d) If the representations about Seller's financial condition made under paragraph 12 shall have been incorrect in any material respect when made;

(e) If Seller shall make a general assignment for the benefit of creditors; admit in writing its inability to pay its debts as they become due; file a petition in bankruptcy or a petition seeking any reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under any present or future bankruptcy, reorganization, insolvency or similar statute, law or regulation or seek the appointment of any trustee, receiver custodian or liquidator of Seller or of all or substantially all of its properties;

(f) If a proceeding is commenced against Seller seeking relief or an appointment of a type described in paragraph 13(e) above and such proceeding is not dismissed within 30 days after the commencement thereof;

(g) If Seller shall have defaulted under this agreement by operation of clause (a) of the second sentence of paragraph 20 below, and such default is not cured within one business day after notice.

14. *Fund's Rights Upon Seller's Default.* If a Seller Event of Default shall have occurred and be continuing, the Fund may, upon one business day's prior notice to Seller (which notice may be the same notice referred to in paragraph 13(b), (c) or (k) and shall not be required to be given in advance in the case of a Seller Event of Default of a type described in paragraph 13(e) or (f)), (a) terminate or accelerate to a date designated by Fund the date fixed for termination of the directly affected repurchase transaction or all of the repurchase transactions hereunder and (b) apply the Securities to the payment of the Sale Price, plus accrued and unpaid interest at the Interest Rate thereon, all reasonable legal or other expenses incurred by the Fund as a result of Seller's default, and, to the extent permitted by applicable law, interest on such accrued and unpaid interest and expenses at the Interest Rate until the obligations of Seller under this agreement have been satisfied by (i) selling the Securities in the principal market for such Securities in a commercially reasonable manner; or (ii) in lieu of sale, by registering or causing to be registered to the account of the Fund the transfer of any securities held by the Custodian free and clear of all interests of the Seller. If any Securities or proceeds of Securities remain after all obligations of Seller under this agreement have been satisfied, the Fund or the Custodian shall promptly return to Seller or its agent the balance of the Securities or proceeds of Securities. Any Cash Collateral held by the Fund shall be applied by the Fund to the amount owed by the Seller and any excess shall be remitted to the Seller. If the Securities are not sufficient to satisfy all such obligations, Seller shall be liable to the Fund for the amount of

remaining obligations plus interest at the then prevailing Effective Federal Funds Rate.

15. *Fund Events of Default.* The occurrence of any of the following shall constitute a "Fund Event of Default:"

(a) If the Sale Price is not paid as specified in paragraph 1 above;

(b) If the Fund shall fail to perform its obligations under paragraph 6 above in respect of a substitution of Securities, and such default is not cured within one business day after notice;

(c) If the Fund shall fail to pay any amount required pursuant to paragraph 9 above, and such default is not cured within one business day after notice;

(d) If the Fund shall fail to return excess Securities as provided in paragraph 11 above, and such default is not cured within one business day after notice;

(e) If the representations made by the Fund in paragraph 4 above shall have been incorrect in any material respect when made;

(f) If the Fund shall make a general assignment for the benefit of creditors; admit in writing its inability to pay its debts as they become due; file a petition in bankruptcy or a petition seeking any reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under any present or future bankruptcy, reorganization, insolvency or similar statute, law or regulation or seek the appointment of any trustee, receiver, custodian or liquidator of the Fund or of all or substantially all of its properties;

(g) If a proceeding is commenced against the Fund seeking relief or an appointment of a type described in paragraph 15(f) above and such proceeding is not dismissed within 30 days after the commencement thereof;

(h) If a final judgment for the payment of money shall be rendered against the Fund, and such judgment shall not have been discharged or its execution stayed pending appeal within 60 days of entry or such judgment shall not have been discharged within 60 days of expiration of any such stay; or,

(i) If the Fund shall have defaulted under this agreement by operation of clause (a) of the second sentence of paragraph 20 below, and such default is not cured within one business day after notice.

16. *Seller's Rights Upon Fund Default.* If a Fund Event of Default shall have occurred and be continuing, Seller may, upon one business day's prior notice to Fund (which notice may be the same notice referred to in paragraph 15(b), (c), (d) or (i) above and shall not be required to be given in advance in the case of Fund Event of Default of a type described in paragraph 15(f) or (g)), (a) terminate or accelerate to a date designated by Seller the date fixed for termination of the directly affected repurchase transaction or all repurchase transactions hereunder and (b) purchase in the principal market therefor in a commercially reasonable manner Eligible Securities with a market value equal to any Securities required to be returned or delivered by Fund but not so returned or delivered, or elect to be deemed for all purposes of this agreement to have purchased such Securities, and in either event apply

the cost of such purchase (including any reasonable expenses incurred in connection therewith) or, in the case of a deemed purchase, the market value of such Securities as of the date of such deemed purchase, against the Sale Price and any other amounts owing by Seller, upon which application the Sale Price and any such other amounts shall be reduced by the amount so applied, Seller shall be released from the obligation to pay any part of the Sale Price other than the positive amount, if any, of the Sale Price after such reduction and Fund shall be released from any obligation to sell, return or deliver such Securities. Seller shall promptly pay Fund any portion of such positive amount (after such reduction) which has not previously been paid. Fund shall pay promptly to Seller any excess of such cost of purchase of replacement Eligible Securities (including expenses as aforesaid) or, in the case of a deemed purchase, such market value of such Securities over the amount of the Sale Price (prior to reduction), plus interest at the applicable Interest Rate on such excess for the period from the date of such purchase or deemed purchase until the date of full payment by Fund at the then prevailing Effective Federal Funds Rate. Notwithstanding anything contained in this agreement, except as expressly provided for in this paragraph 16 Seller shall under no circumstances whatsoever have any obligation or liability to Fund in respect of any repurchase transaction following the failure of Fund to pay the applicable Sale Price or return or deliver the applicable Securities as and when required by the terms of this agreement.

17. *Notices.* Except as otherwise expressly provided herein, all notices under this agreement shall be telephonic or written and given to the party entitled to

receive such notices at the following telephone numbers and addresses:

If to Seller:

Attention:

If to Fund: ----------

(Name of Fund)
421 Seventh Avenue
Pittsburgh, PA 15219
Attention: Peter C. Hurley
(412) 288-1975

or to such other telephone numbers or addresses as either party may furnish the other party by written notice under this paragraph. All written notices which are required or provided to be given hereunder shall be effective upon actual receipt by the party to which such notice is given.

18. *Security Interest.* Notwithstanding any other provision of this agreement, in the event that a repurchase transaction hereunder is deemed not to be a sale (a) Seller shall be deemed to have hereby granted to the Fund a first security interest in and a lien upon, and to have pledged the Cash Collateral and Securities (together with all principal, interest and other sums paid by or on behalf of the issuer in respect of the Securities and collected by the Fund and all rights related thereto, all proceeds thereof and all substitutions therefor) applicable to such repurchase transaction as security for the performance by Seller of its obligations in respect of such repurchase transaction and (b) the existence of such first security interest, lien and pledge shall be deemed not to violate the representations and warranties in respect of such

Securities made by Seller in paragraph 5 above. Notwithstanding the foregoing sentence, it is the intention of the Seller and the Fund that each such transaction shall be a "sale" within the meaning of the New York Uniform Commercial Code.

19. *Segregation.* All Securities and Cash Collateral held by the Custodian for the account of the Fund shall be segregated from other securities and cash in the possession of the Custodian and shall be identified as subject to this agreement. Segregation may be accomplished by appropriate identification on the books and records of the Custodian.

20. *Single Agreement.* Seller and Fund hereby acknowledge that they consider all transactions and agreements between them to constitute a single business and contractual relationship and to have been made in consideration of each other and this agreement. Therefore, (a) each party hereby agrees to fulfill all of its obligations to the other party with respect to any transaction or agreement between them, and agrees that a default in the performance of any such obligations shall constitute a default hereunder, (b) each party shall have a right of setoff against the other party of amounts owing hereunder and any other amounts or obligations owing in respect of any other agreement or transaction whatsoever, and (c) payments and deliveries made by either party hereunder shall be considered to have been made in consideration of payments and deliveries made by the other party with respect to any other agreement or transaction between them, and the obligations to make any such payments and deliveries may be applied against each other and netted.

21. *Termination of Agreement.* This agreement may be terminated by either party on ten business days' written notice to the other party; provided, however, that such termination shall not affect any repurchase transaction then outstanding or initiated thereafter and prior to the date of termination specified in such notice.

22. *General Provisions.* This agreement supersedes any other agreement between the parties concerning repurchase transactions, except for the additional terms and conditions appearing on each confirmation delivered pursuant to paragraph 3, shall not be assignable by either party without prior written consent of the other party, shall be binding upon and inure to the benefit of the parties and their respective successors and assigns, shall not be changed except by an instrument in writing signed by each of the parties, and shall be governed by the laws of the State of New York.

---------- (SELLER)

---------- By ----------
Date (Title)

FUND*

---------- By ----------
Date Vice President

---

* This agreement is executed on behalf of each Fund listed on Exhibit A to this agreement. John A. Staley, IV, is duly and properly authorized by each Fund listed on Exhibit A to this agreement to enter into this agreement on its behalf.

EXHIBIT A

AARP U.S. GOVERNMENT MONEY MARKET TRUST
AMERICAN LEADERS FUND, INC.
AUTOMATED CASH MANAGEMENT TRUST
AUTOMATED GOVERNMENT MONEY TRUST
BOSTON FOUNDATION FUND INCORPORATED
EGT MONEY MARKET TRUST
FEDERATED CAPITAL APPRECIATION FUND, INC.
FEDERATED CORPORATE CASH TRUST
FEDERATED EXCHANGE FUND, LTD
FEDERATED GNMA TRUST
FEDERATED GOVERNMENT SECURITIES TRUST
FEDERATED GROWTH TRUST
FEDERATED HIGH INCOME SECURITIES
FEDERATED HIGH YIELD TRUST
FEDERATED INCOME TRUST
FEDERATED INTERMEDIATE GOVERNMENT TRUST
FEDERATED MASTER TRUST
FEDERATED MORTGAGE SECURITIES INCOME FUND
FEDERATED SHORT-INTERMEDIATE GOVERNMENT TRUST
FEDERATED SHORT-INTERMEDIATE MUNICIPAL TRUST
FEDERATED STOCK TRUST
FORT WASHINGTON MONEY MARKET FUND
FUND FOR U.S. GOVERNMENT SECURITIES
GOVERNMENT MONEY INSTRUMENTS TRUST
EDWARD D. JONES & CO. DAILY PASSPORT CASH TRUST
LEGG MASON CASH RESERVE TRUST
LIQUID CASH TRUST
LUTHERAN BROTHERHOOD FUND
LUTHERAN BROTHERHOOD INCOME FUND
LUTHERAN BROTHERHOOD MONEY MARKET FUND
LUTHERAN BROTHERHOOD MUNICIPAL BOND FUND
MONEY MARKET INSTRUMENTS TRUST

MONEY MARKET MANAGEMENT
MONEY MARKET TRUST
MORGAN KEEGAN DAILY CASH TRUST
SUTRO MONEY MARKET FUND
TRUST FOR CASH RESERVES
TRUST FOR SHORT-TERM U.S. GOVERNMENT SECURITIES
TRUST FOR U.S. TREASURY OBLIGATIONS

---------- Seller
---------- Fund

EXHIBIT B

(LOGO) nebraska department of revenue

Revenue Ruling 22-87-4
Supersedes Rev. Rul. 22-87-1

Individual Income Tax – Dividends Received from a Regulated Investment Company for Tax Years After 1986. IF FOR EVERY QUARTER OF THE TAXABLE YEAR, 80 PERCENT OR MORE OF THE ASSETS OF A REGULATED INVESTMENT COMPANY ARE DIRECTLY OWNED UNITED STATES GOVERNMENT OBLIGATIONS, THE ENTIRE DIVIDEND RECEIVED FROM THE REGULATED INVESTMENT COMPANY IS EXEMPT FROM NEBRASKA INDIVIDUAL INCOME TAX. IF FOR EVERY QUARTER OF THE TAXABLE YEAR, 80 PERCENT OR MORE OF THE ASSETS OF A REGULATED INVESTMENT COMPANY ARE DIRECTLY OWNED OBLIGATIONS OF ANY STATE, THE DISTRICT OF COLUMBIA, OR THEIR INSTRUMENTALITIES, THE PORTION OF

THE INCOME ATTRIBUTABLE TO NEBRASKA OBLIGATIONS DOES NOT HAVE TO BE ADDED TO ADJUSTED GROSS INCOME FOR NEBRASKA INDIVIDUAL INCOME TAX PURPOSES.

Advice has been requested concerning whether distributions by a regulated investment company investing in U.S. Government obligations or state municipal obligations are subject to Nebraska individual income tax.

A regulated investment company meeting the requirements for classification under sections 851 and 852 of the Internal Revenue Code is not taxed on amounts distributed to shareholders. The shareholders receiving dividends are liable for income tax depending upon the type of income distributed.

Nebraska law provides that if for every quarter of the taxable year, 80 percent or more of the assets of a regulated investment company are directly owned United States Government obligations, the entire dividend for the taxable year received from the regulated investment company is exempt from Nebraska individual income tax. If for any one quarter of the taxable year, less than 80 percent of the assets of a regulated investment company are directly owned United States Government obligations, the entire dividend for the taxable year is subject to Nebraska individual income tax. For a list of obligations considered U.S. Government obligations, see Revenue Ruling 22-87-2 and the instructions to the Nebraska Individual Income Tax Return, Form 1040N.

If for every quarter of the taxable year, 80 percent or more of the assets of a regulated investment company are directly owned obligations of any state, the District of

Columbia, or their instrumentalities, the portion of the dividend attributable to Nebraska obligations does not have to be added to adjusted gross income for Nebraska individual income tax purposes. If for any one quarter of the taxable year, less than 80 percent of the assets of a regulated investment company are directly owned obligations of any state, the District of Columbia, or their instrumentalities, the entire dividend for the taxable year is subject to Nebraska individual income tax.

APPROVED:

/s/ Donald S. Leuenberger
Donald S. Leuenberger
State Tax Commissioner

September 11th, 1987

(LOGO) nebraska department of revenue

Revenue Ruling 22-87-2

Individual Income Tax – Deduction of Income From United States Government Obligations for tax years after 1986.

ALLOWABLE DEDUCTIONS FROM FEDERAL ADJUSTED GROSS INCOME FOR NEBRASKA INDIVIDUAL INCOME TAX PURPOSES ARE ONLY THOSE ITEMS SUBJECT TO FEDERAL TAXATION BUT EXEMPT FROM STATE TAXATION UNDER THE LAWS OF THE UNITED STATES.

Advice has been requested whether interest or dividend income from United States government obligations is deductible for Nebraska individual income tax purposes.

Nebraska law provides that interest or dividends from obligations of the United States and its territories and possessions or of any United States authority, commission, or instrumentality, if included in federal gross income but exempt from state income taxation under the laws of the United States, shall be subtracted from federal adjusted gross income. Section 77-2716(1), R.S.Supp., 1987.

Interest or dividend income included in federal adjusted gross income from the following sources is deductible for Nebraska individual income tax purposes:

(1) United States government bonds, such as series HH and EE, (interest is deductible only if the bond has been issued after March 1, 1942);

(2) United States Treasury Bills (interest is deductible only if the bill has been issued after March 1, 1942);

(3) United States government notes;

(4) United States government certificates;

(5) Commodity Credit Corporation;

(6) Federal Home Loan Banks;

(7) Federal Reserve Banks (dividends are deductible only if from stock issued after March 1, 1942);

(8) Federal Savings and Loan Insurance Corporation;

(9) Tennessee Valley Authority securities;

(10) Interest on debentures issued to mortgagees of mortgages foreclosed under provisions of the National Housing Act if insured after February 3, 1938;

(11) Postal Service bonds;

(12) Retirement bond as provided for by I.R.C. section 409 (issuance discontinued after April 30, 1982);

(13) Farm Credit Bank Consolidated System Wide bonds;

(14) Farm Credit System including the following members unless noted elsewhere:

a. Federal Land Banks (dividends are deductible only if from stock issued after March 28, 1942),

b. Federal Land Bank Association (dividends are deductible only if stock issued after March 28, 1942),

c. Federal Intermediate Credit Banks,

d. Any other institution chartered by and subject to the supervision of the Farm Credit Administration unless noted elsewhere;

(15) General Services Administration Participation Certificates.

Interest but not dividend income included in federal adjusted gross income from the following sources is deductible for Nebraska individual income tax purposes:

(1) Federal Deposit Insurance Corporation;

(2) Student Loan Marketing Association;

(3) Production Credit Association;

(4) Banks for Cooperatives.

Interest or dividend income received from the following sources is taxable and cannot be deducted from federal adjusted gross income for Nebraska individual income tax purposes:

(1) Federal or State Banks;

(2) Federal or State Savings and Loan Associations;

(3) Building and Loan Associations;

(4) Postal Savings Accounts (discontinued in 1966);

(5) Export Import Bank bonds;

(6) Federal or State Credit Unions;

(7) Interest on debentures issued to mortgagees of mortgages foreclosed under the provisions of the National Housing Act if insured prior to February 3, 1938;

(8) Interest on federal income tax refunds;

(9) Farmers Home Administration;

(10) New Community debentures;

(11) Merchant Marine bond;

(12) Ship Financing bond;

(13) U.S. Merchant Marine Ship notes;

(14) U.S. Merchant Marine Offshore Ship Service notes;

(15) Interest on state income tax refunds;

(16) Federal Home Loan Mortgage Corporation;

(17) World Bank;

(18) International Bank for Reconstruction and Development bonds;

(19) Asian Development Bank notes and bonds;

(20) InterAmerican Development Bank bonds;

(21) Interest from U.S. Government Life Insurance (unless exempted by I.R.C. section 101(d)(1)(B);

(22) Bankers' Acceptances;

(23) Certificates of Deposit;

(24) Penn Central Transportation certificates;

(25) Federal Financing Bank;

(26) Federal National Mortgage Association;

(27) Government National Mortgage Association;

(28) Chrysler Corporation secured notes;

(29) Lockheed convertible bonds;

(30) Washington Metropolitan Area Transit Authority Bonds.

The specific source and dollar amount of each item claimed as income from the U.S. government is to be identified on Nebraska Schedule I or on an attached sheet and filed with Form 1040N. Failure to provide adequate information shall result in the disallowance of part or all of the claimed deduction from federal adjusted gross income.

The items that are allowable deductions from federal adjusted gross income for Nebraska individual income tax purposes are only those items includable in gross income for federal income tax purposes but exempt from state income tax under the laws of the United States.

APPROVED:

/s/ Donald S. Leuenberger
Donald S. Leuenberger
State Tax Commissioner

September 2nd, 1987

IN THE DISTRICT COURT OF
LANCASTER COUNTY, NEBRASKA

JOHN LOEWENSTEIN, Plaintiff, v. STATE OF NEBRASKA DEPARTMENT OF REVENUE, Defendant.	Docket 428 Page 177 AFFIDAVIT (Exhibit No. 3 Received July 23, 1990)

STATE OF NEBRASKA)
)
COUNTY OF LANCASTER)

COMES NOW the affiant, having been first duly sworn, hereby makes oath as follows:

1. I am Donald O. Ellingson. I reside at Rural Route 1, Denton, Nebraska 68339. I am an employee of the Nebraska Department of Revenue. I am a Tax Law Manager in the Tax Policy Division. I am an attorney and an accountant. I am a member of the Nebraska State Bar Association and have passed the CPA exam. I have also completed some graduate work in accounting at the University of Nebraska.

2. As a Tax Law Manager in the Tax Policy Division, my responsibilities include:

a. Researching and drafting proposed legislation,

b. Resolution of technical tax issues,

c. Formulation of positions for the Department,

d. Preparation and presentation of legislative testimony on tax issues,

e. Reviewing forms, rulings, and other publications for technical accuracy and overall consistency.

Within the scope of my responsibilities with the Nebraska Department of Revenue, I have had opportunity to examine repurchase agreements several different times and am familiar with them. I have been involved with the development of the position of the Nebraska Department of Revenue in regard to taxation of repurchase agreements.

3. For the purposes of my discussion of my conclusions on repurchase agreements, I will use the following transaction, which I have found to be a typical transaction based upon my research.

Example No. 1

The bank is the owner of federal bonds. The bank will enter into a repurchase transaction with a fund. The bank will transfer bond to the fund and the fund will transfer money to the bank. The bank will repurchase the bond in three days at a specific price and rate of interest.

4. This is typical of the transactions that I have examined in the relation to their taxability and is a transaction that would be entered into under the sample agreement that is attached hereto and incorporated by reference as Exhibit A. The sample agreement was provided by another taxpayer in a similar situation who

requested an opinion of taxability of the transaction from the Nebraska Department of Revenue. This sample agreement is typical of the agreements that I have seen. This agreement covers repurchases that have a specific date for the purchase, or those that are on demand. I have used the sample agreement for the purposes of this Affidavit since the taxpayer has not furnished any copies of the actual repurchase agreements that have been entered into.

5. I have noted that there are several very important provisions in the sample agreement that were considered by the Department of Revenue and myself in determining the taxation of the income received on repurchase agreements.

a. The purchase price for the bond will be the amount paid for the bond by the fund, plus the amount of interest that will have accrued before the repurchase of the bond.

b. The bank reserves the right to substitute another bond of equal market value for the bond transferred before the repurchase.

c. If the value of the bond drops below the margin percentage, the bank will have to provide an additional bond to insure that the market value of the bonds held by the fund are higher than the margin percentage. A similar provision would require the fund to return a bond if the market value of the bonds exceeded the margin percentage.

d. Any amounts of interest or principal received by the fund from the United States have to be turned over to the bank.

e. The bank has to provide information on its financial condition to the fund, and to keep the fund updated on changes in its financial condition.

f. The agreement contains the grant of a security interest in the bond in favor of the fund by the bank if the agreement is not considered to be a sale and repurchase.

g. The agreement also contains a provision that the agreement is considered one agreement and that the various parts of the agreement are made in consideration of the other parts of the agreement.

6. In evaluating these agreements for the Nebraska Department of Revenue, I have looked at the above terms to determine if the agreement does in fact constitute a sale in [sic – and] repurchase, or if the agreement is a financing arrangement with the bonds held by the bank being transferred as collateral.

7. Basically, the funds want us to look at each of the steps of the agreement separately. Myself and the Department consider the pieces of the agreement as a series of separate transactions. When I do so, I am aware that some of the courts have looked at this as a series of transactions. I am aware that generally these courts have been looking at a situation that would prevent the completion of the remainder of the agreement, such as bankruptcy, where the court has been looking at whether public bodies that are not able to make loans can participate in the repurchase agreements.

8. I am also aware that generally in taxation matters, the transaction is viewed as a whole. The steps are

normally collapsed or ignored to prevent a tax benefit solely because of the form or step structure of the transaction, especially in situations like this where the various steps are interdependent and each step is a part of their consideration of the next step [please see item 5(g) above].

9. I am also aware that the Internal Revenue Service has used this approach when evaluating repurchase agreements on municipal or state obligations. I know that the IRS has not allowed the income on repurchase agreements to be excluded from federal taxations. I am aware that the courts which have looked at this issue for the purposes of taxation have generally looked at the substance rather than the form of the transaction.

10. In viewing the economic substance of the agreement, I note that the bank owns the bond before the transactions begin and it owns the same bond after the transaction is over. I note that the bank had the use of the fund's money for a period of time, and the fund has earned some interest. I note further that the amount of interest was based on the agreement, and not on the interest rates of the bond.

11. I conclude that by agreeing to the repurchase price, the bank isolated the fund from any risk of a decrease in the value of the bonds. The fund was limited in what it could do with the bond prior to a default by the bank. Effectively during the period before the repurchase, the bank retains title to the bonds which are transferred as security for the loan from the fund to the bank.

12. The transaction is viewed by myself and the Nebraska Department of Revenue as a collaterized loan.

Therefore, the income received by the fund is from the bank under the agreement, and is not interest from the United States on a U.S. obligation. Since the interest is not from U.S. obligations, the income can't be excluded from state taxation.

13. I was also connected with the drafting of the legislation on the state taxation of distributions from mutual funds that hold federal obligations. I assisted with the drafting of the current Nebraska statutes which allow for the exclusion by a shareholder of the income received from a mutual fund that holds at least 80% of its assets and federal obligations. If the fund holds less than 80% of its assets and federal obligations, the income from the fund is taxed.

14. It was my intention when participating in the drafting of the Nebraska statute to base it on the federal rules established from mutual funds that hold municipal obligations. Generally the character or source of income received by another entity is lost when the income is transferred to an individual investor. An investor in General Motors can't exclude a portion of the dividends received because GM had income from government obligations.

15. I am aware that the federal tax code allows an exception for certain entities, including mutual funds, under certai circumstances. The same 80% rule used by Nebraska is applied by the Internal Revenue Code to determine whether distributions from mutual funds holding municipal obligations can be excluded from federal income taxation.

16. Our state has adopted the federal rules on preserving the character of the income when received by the investor. When the fund does not have enough of its assets and [sic – in] proper securities, the income is considered to be received from the fund and is taxable at either the state or federal level. When a percentage is met, then the income is considered to retain its character and it can be included [sic – excluded] from either state or federal taxation.

17. I have reviewed the attached deposition of Stewart Brown, attached hereto and incorporated as Exhibit B. I concur with the conclusions presented therein and adopt them as my own.

Further affiant sayeth not.

/s/ Donald O. Ellingson
Donald O. Ellingson

Subscribed and sworn to before me this 23rd day of July, 1990.

/s/ Sharon S. French
Notary Public
GENERAL NOTARY
State of Nebraska
SHARON S. FRENCH
My Comm. Exp. Oct. 26, 1993

(Attachments To Exhibit 3 Omitted In Printing).

Supreme Court, U.S.
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No. 93-823

In The

Supreme Court of the United States

October Term, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE,

Petitioner,

v.

JOHN LOEWENSTEIN,

Respondent.

On Writ Of Certiorari
To The Supreme Court Of Nebraska

BRIEF OF PETITIONER

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QUESTION PRESENTED

Whether a state tax imposed on income received by shareholders of mutual funds derived from repurchase agreements involving federal securities violates 31 U.S.C. § 3124 (1988).

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In The

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STATE OF NEBRASKA, DEPARTMENT OF REVENUE,

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JOHN LOEWENSTEIN,

Respondent.

On Writ Of Certiorari
To The Supreme Court Of Nebraska

BRIEF OF PETITIONER

OPINIONS BELOW

The opinion of the Supreme Court of Nebraska (Pet. Cert. App. A-1) is reported as *Loewenstein v. State*, 244

Neb. 82, 504 N.W.2d 800 (1993). The opinion of the District Court of Lancaster County, Nebraska (Pet. Cert. App. A-20), and the Order amending the district court's opinion (Pet. Cert. App. A-27), are not reported.

JURISDICTION

The opinion and judgment of the Supreme Court of Nebraska was entered on August 27, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

31 U.S.C. § 3124 provides, in pertinent part:

> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax. . . .

The Supremacy Clause of the United States Constitution, Article VI, clause 2, provides, in pertinent part:

> This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . , shall be the supreme Law of the Land. . . .

STATEMENT OF THE CASE

The controversy in this case arose as a result of the State of Nebraska's taxation of income received by Respondent John Loewenstein from investments in mutual funds. Loewenstein, a Nebraska resident, owned shares in two mutual funds, the Trust for Short-Term U.S. Government Securities and the Trust for U.S. Treasury Obligations [the "Trusts"]. The Trusts are no-load, diversified investment companies whose primary objective is to receive current income from ownership of U.S. government obligations (J.A. 61). The Trusts invest only in U.S. government obligations and distribute all of their income each year to their shareholders (J.A. 62-63).

The Trusts invest in U.S. government securities either by direct purchase of federal obligations or through "repurchase agreements", commonly called "repos" (J.A. 62). A standard repurchase agreement consists of a two-part transaction. In step one a party who holds federal obligations and who is seeking cash (the seller-borrower) sells the government obligations to a party who has available cash and who is seeking to earn interest on idle funds, the buyer-lender (in this case, the Trusts). At the time the contract is formed the buyer-lender agrees to sell back to the seller-borrower, and the seller-borrower agrees to repurchase, the obligations at a higher price than at step one. The resale price includes interest for the period of the sale. The interest paid to the buyer is less than that earned by the federal securities; the difference between the purchase price and the sale price is the seller-borrower's margin of profit (J.A. 62-63; Pet. Cert. App. A-5 to A-7). The income distributed to Loewenstein

by the Trusts flowed both from the Trusts' direct investment in federal securities and from the Trusts' participation in repurchase agreements.

Nebraska imposes a tax on an individual's "federal adjusted gross income", with certain modifications. Neb. Rev. Stat. § 77-2715(2) (1990). One such modification is an adjustment reducing income subject to taxation for "interest or dividends received by the owner of obligations of the United States . . . but exempt from state income taxes under the laws of the United States;. . . . " Neb. Rev. Stat. § 77-2716(1)(a) (Cum. Supp. 1992). In 1985, the Nebraska Department of Revenue issued a Revenue Ruling determining that income received from repurchase agreements involving federal obligations was subject to Nebraska income tax.[1] Based on the Department's Revenue Ruling,

---

[1] Revenue Ruling 22-85-1 provides, in part:

> A repurchase agreement is essentially a short-term loan, bearing interest at a specified rate, whereby an owner of government or agency securities obtains funds from a customer, a financial institution, or a broker/dealer. The loan is secured by certain Treasury Bills or other obligations of the federal government owned by the borrower. The terms of the repurchase agreement generally provide for the sale of securities with a prompt repurchase by the owner. The party providing the funds does not receive the actual federal government obligations securing the investment, but does receive a collateral receipt identifying the securities pledged to or sold to the party providing the funds. The risk of ownership and title to the securities does not shift from the operator of a repurchase pool to the investor providing short-term funds. The interest earned on the United States government obligations remains the income of the owner who submitted the securities as collateral for the loan.
>
> The interest income received from repurchase agreements involving obligations of the United States government is income to the investor who provides the funds as a loan secured by government securities. This interest income which is received from repurchase agreements involving obligations of the United States government is subject to the Nebraska individual income tax. It is not to be subtracted from a taxpayer's federal taxable income on the Nebraska return.

Loewenstein was required to pay Nebraska income taxes on the interest income he received from the Trusts attributable to the Trusts' participation in repurchase agreements involving federal securities.

Loewenstein instituted a declaratory judgment action in the District Court of Lancaster County, Nebraska, asking that another Revenue Ruling relating to the taxation of income from the Trusts issued by the Department (Revenue Ruling 22-87-4) be declared invalid as contrary to 31 U.S.C. § 3124 and the Supremacy Clause of the United States Constitution (J.A. 3).[2] Subsequently, the

---

[2] Loewenstein instituted the action pursuant to Neb. Rev. Stat. § 84-911(1) (1987), which provides:

> The validity of any rule or regulation may be determined upon a petition for declaratory judgment thereon addressed to the district court of Lancaster County if it appears that the rule or regulation or its threatened application interferes with or impairs or threatens to interfere or impair with the legal rights or privileges of the petitioner. The agency shall be made a party to the proceeding. The declaratory judgment shall be rendered whether or not the petitioner has first requested the agency to pass upon the validity of the rule or regulation in question.

parties jointly filed a motion to amend the pleadings to include a request for a ruling on the validity of Revenue Ruling 22-85-1. (J.A. 17). The district court found that both rulings violated § 3124 and the Supremacy Clause, and, therefore, declared them void. (Pet. Cert. App. A-20 and A-27). The State appealed the district court's decision declaring invalid Revenue Ruling 22-85-1.[3]

On appeal, a majority of the Supreme Court of Nebraska affirmed the district court's finding that Revenue Ruling 22-85-1 was invalid. The majority recognized that most courts which have considered the issue have determined that income attributable to repurchase transactions involving federal securities is not exempt from state taxation under § 3124. (Pet. Cert. App. A-11 to A-12). It declined, however, to follow this line of authority, stating "[t]he rationale applied by these courts in determining whether a mutual fund shareholder's income from a repo transaction is exempt under § 3124 is based entirely on whether that party is deemed the true, or direct, owner of the securities." (Pet. Cert. App. A-12). Stating "[w]e do not believe that direct ownership determines whether income from a repo agreement is exempt under § 3124 . . . ", the majority concluded that "the income received by the appellee in this case, at the very least, is considered indirectly in computation of the tax. In addition, the state tax clearly imposes a burden on the

[3] The State did not appeal the district court's decision finding Revenue Ruling 22-87-4 invalid. The substance of the ruling was effectively repealed by the enactment of 1991 Neb. Laws, LB 773, § 13 (*codified at* Neb. Rev. Stat. § 77-2716 (Cum. Supp. 1992)).

market for federal securities." (Pet. Cert. App. A-12 to A-13). The majority thus found "that the income received by the appellee from repo transactions executed by the trusts involving federal securities is exempt from state taxation under § 3124." (Pet. Cert. App. A-13).

In a dissenting opinion, Justice Caporale, joined by Justice Grant, expressed disagreement with the majority's opinion, stating:

> [W]hen stripped to their essence, the transactions in question are nothing more than ones in which the plaintiff-appellee, John Loewenstein, participated as a lender in loans secured by various governmental obligations. Therefore, state taxation of the income Loewenstein earned through those participations is not precluded by the Supremacy Clause of the U.S. Constitution through the provisions of 31 U.S.C. § 3124 (1988), and Nebraska Department of Revenue Ruling 22-85-1, issued by the defendant-appellant, State of Nebraska, Department of Revenue, is valid.

(Pet. Cert. App. A-14).

SUMMARY OF ARGUMENT

The Nebraska Supreme Court erroneously held that Nebraska's tax on income distributed to Respondent Loewenstein as a shareholder of mutual funds [the Trusts] derived from repurchase agreements involving federal securities was precluded by 31 U.S.C. § 3124. The computation of Nebraska's tax did not consider, directly

or indirectly, either federal obligations or the interest on such obligations within the meaning of § 3124.

The Trusts are regulated investment companies under the Internal Revenue Code Subchapter M, established under the Investment Company Act of 1940. The Trusts invest in U.S. government securities either by direct purchase of federal obligations or through "repurchase agreements", commonly referred to as "repos". The "repos" engaged in by the Trusts are agreements in which a party owning federal securities and seeking cash, the seller-borrower, "sells" the securities to the Trusts, the buyer-lender. The repo provides that the seller-borrower agrees to repurchase the securities, and the buyer-lender agrees to resell the securities, at a later date or on demand, plus an agreed upon rate of "interest" to be paid by the seller-borrower. The "interest" paid by the seller-borrower on repurchase is based on prevailing market rates paid on loans or financing transactions of similar maturity and risk; it does not bear any relationship to the interest rate or yield on the federal securities.

The economic substance of a repurchase agreement has been universally recognized as that of a secured loan in which the obligations underlying the transaction serve as collateral for what is in effect a loan of funds to the seller-borrower. Federal courts construing the exemption for interest on state and local obligations under I.R.C. § 103(a) have recognized that repurchase agreements involving municipal bonds are, in economic effect, secured loans, holding that the buyer-lender is not the true owner of the underlying securities, and, therefore, does not receive interest income exempt from federal taxation. State courts have relied on these federal court

precedents in holding that, based on the economic substance of repo transactions, income from repos involving federal obligations is not exempt from state taxation under § 3124.

While the characterization of repos may well justify different treatment in other contexts, there is no reason for the Court to depart from the well established rule that, for tax purposes, the economic substance of the transaction, rather than mere form, should govern the taxation of income derived from repurchase agreements. The provisions of the repos engaged in by the Trusts clearly establish that the agreements are, in economic substance and reality, loans by the Trusts in which federal securities serve as collateral. The "interest" received by the Trusts under their repos is merely "interest" income paid to the Trusts by private party seller-borrowers; it is not "interest" paid by the United States on the federal obligations.

Section 3124 prohibits state taxation only of obligations of the United States or the interest thereon. The Court has construed this prohibition to "'extend[ ] to **every form** of taxation that would require that either the obligations or the interest thereon, or both, **be considered, directly or indirectly, in the computation of the tax**' (emphasis supplied)." *American Bank and Trust Co. v. Dallas County*, 463 U.S. 855, 862 (1983). The Court's decisions confirm that the exemption extends only to forms of state taxation which "consider" obligations of the United States or the "interest" on such obligations "in computing [the] tax". Neither federal obligations, nor the interest paid by the United States on such obligations, were considered by Nebraska in computing the tax imposed on

income distributed by the Trusts to Loewenstein derived from repos. In the repurchase transactions at issue, the federal obligations were not actually owned by the Trusts, but were taken as security for what were, in economic effect, loans by the Trusts to seller-borrower/repurchasers. The obligations themselves were not "taken into account" or "included in the accounting" (*American Bank and Trust Co. v. Dallas County*, 463 U.S. at 862) in the computation of the tax, as the measure of the tax had nothing to do with the value of the federal securities. Moreover, the "interest" received by the Trusts was not the interest paid by the federal government on the obligations, but, rather, was "interest" paid by the seller-borrower/repurchasers at the rate agreed to by the parties under the repo agreements. Nebraska did not impose a tax on federal obligations or the interest thereon. The computation of Nebraska's tax on Loewenstein did not require consideration of federal obligations or the interest on such obligations. Therefore, the tax was not prohibited by § 3124.

Nor is there any support for the Nebraska Supreme Court's conclusion that the tax contravened § 3124 because it impermissibly diminished the attractiveness of federal obligations, and impaired the borrowing ability of the United States. The evidence relied upon by the court below, consisting solely of an affidavit filed in a bankruptcy case by Peter D. Sternlight, executive vice president of the Federal Reserve Bank of New York, relates only to concerns of the Federal Reserve which arose as a result of a bankruptcy court decision characterizing repos

as secured loans under the Bankruptcy Code. The treatment of repos as secured loans for bankruptcy law purposes was of importance to both the Federal Reserve and the securities industry, as, under the Code's automatic stay provisions, a secured loan characterization would have barred repo purchasers from liquidating securities in the event a seller filed for bankruptcy. Sternlight's testimony before Congress on this issue reflects the Federal Reserve was concerned with the threat to the liquidity and safety of the repo market posed by the treatment of repos under the bankruptcy laws. Congress dealt with this problem by the enactment of 11 U.S.C. § 559, which effectively neutralized these concerns by granting purchasers of securities under repos the right to liquidate the securities immediately upon a seller-repurchaser's bankruptcy. Neither Sternlight's affidavit, nor his testimony before Congress, espoused the view that state taxation of repo income posed any threat to the liquidity or safety of the repo market. Sternlight also expressed no opinion that state taxation of repo income would impair the investment attractiveness of federal securities, or that state taxation of repo income would impede the borrowing power of the United States. The record simply does not support the conclusion reached by the court below.

While the Court has recognized that the exemption mandated by § 3124 is "broad" (*Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 395 (1983)) and "sweeping" (*American Bank and Trust Co. v. Dallas County*, 463 U.S. at 862), it has also stated that the exemption "is not a tax shelter" (*First Nat'l Bank of Atlanta v. Bartow Cty. Bd. of Assrs.*, 470 U.S. 583, 597 (1985)), and "should not be expanded or

modified in any degree by the judiciary." (*Smith v. Davis*, 323 U.S. 111, 119 (1944)). The Court has further counseled that it "must proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly established." *Rockford Life Ins. Co. v. Dept. of Revenue*, 482 U.S. 182, 191 (1987). The extension of § 3124 by the court below to Nebraska's taxation of income distributed to Loewenstein by the Trusts resulting from repos involving federal obligations is inconsistent with the language and intent of the statute. The Nebraska Supreme Court's decision should be reversed.

ARGUMENT

NEBRASKA'S TAXATION OF INCOME RECEIVED BY SHAREHOLDERS OF MUTUAL FUNDS DERIVED FROM REPURCHASE AGREEMENTS INVOLVING U.S. GOVERNMENT OBLIGATIONS DOES NOT VIOLATE 31 U.S.C. § 3124.

The state court erroneously held that Nebraska's taxation of income distributed to Loewenstein as a shareholder of mutual funds derived from repurchase agreements involving federal obligations violated § 3124 because "the income received by [Loewenstein] in this case [was], at the very least, [ ] considered indirectly in the computation of the tax" (Pet. Cert. App. A-13).[4] In

[4] As noted by the amici states, several state courts have held that either § 3124 or the doctrine of intergovernmental tax immunity preclude state taxation of distributions to mutual fund shareholders based on interest received by the Trusts from direct ownership of federal obligations. Brief of Amici Curiae States of California, et al. at 4-5 n.8. Nebraska did not raise this issue in the proceedings below. Accordingly, while the Court may find that this issue is "fairly included" in the question presented within the meaning of Rule 14.1(a), Nebraska will not argue the merits of this issue.

reaching this conclusion, the state court failed to apply the proper test for determining the characterization for tax purposes of income derived from repurchase transactions, and erroneously construed and applied the scope of the exemption from taxation required by § 3124.

A. Nebraska's Tax on Income Distributed to Mutual Fund Shareholders Derived from Repurchase Agreements Does Not "Consider" U.S. Government Obligations or Interest on Such Obligations Within the Meaning of § 3124.

1. Repurchase Agreements and their Uses.

a. The Nature of Repurchase Agreements.

Repurchase agreements, or "repos", "are contracts involving the *simultaneous sale and future repurchase* of an asset, most often Treasury securities". M. Stigum, *The Money Market* 576 (3d ed. 1990) (emphasis in original). A standard repo involves a two-step transaction. In the first step, a party holding federal securities (the seller), transfers the securities to another party (the buyer), in exchange for cash. The second step consists of the contemporaneous agreement by the seller to repurchase the securities at the original sale price, plus an agreed upon amount of "interest" at a specified date (J.A. 62). The repurchase price of government securities subject to a

repo is less than the market value of the securities (J.A. 63). The repurchase price is equal to the original sale price, plus the negotiated interest. The interest paid by the seller upon repurchase is less than the interest rate accruing on the securities (J.A. 63). "The interest paid at the maturity date of the repo agreement does not bear any relationship to the interest rate or yield on the underlying security, but rather is based on the prevailing market rate paid on investments or financing transactions of similar maturity and risk." *Matter of Bevill, Bresler & Schulman Asset Management Corp.*, 67 B.R. 557, 567 (D.N.J. 1986) ["*Bevill*"].[5]

"Despite the fact that repos and reverses take the form of sequential sales and repurchases, . . . the *economic essence* of the transaction is that it is a *collateralized loan*, not a pair of securities trades." M. Stigum, *supra*, at 577 (emphasis in original). Because, from an economic perspective, repos are recognized as collateralized loans, the "seller" is often denominated as the "borrower", and the "buyer" is referred to as the "lender". *SEC v. Miller*, 495 F. Supp. 465, 467 (S.D.N.Y. 1980).

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[5] Repurchase transactions are referred to as "repos" and "reverse repos". From the seller's perspective, the transaction is called a "repo". Viewed from the "buyer's" perspective, the transaction is called a "reverse repo". *Bevill*, 67 B.R. at 567. Technically, the repo transactions entered into by the Trusts under the General Repurchase Agreement involved "reverse repos" from the Trusts' perspective, as the Trusts were the "buyers" in these transactions (J.A. 65).

b. The Repo Market.

"Dealers first began to use the repo market to finance their positions shortly after World War II. Later, as large banks began to practice active liability management, they joined the dealers in the repo market, using it to finance not only their dealer positions, but their government portfolios. Over the years, the market, which was initially small, has grown dramatically." M. Stigum, *supra*, at 580-81. The repo market contains three types of participants: issuers, providers, and investors. Issuers include banks, savings and loans, the Federal Reserve, and private securities dealers. The primary providers of government securities include dealers underwriting new issues of government securities, the Federal Reserve, securities investors, and money market arbitrageurs. Finally, investors in the market include trust accounts, pension funds, credit unions, municipalities, money market funds, banks, savings and loans, corporations, and individuals. Comment, *The Need for a Uniform Classification of Repurchase Agreements: Reconciling Investor Protection with Economic Reality*, 36 Am. U. L. Rev. 669, 669 n.1 (1987).

Participants in the repo market use repos for a variety of reasons. The Federal Reserve, through the Federal Open Market Committee and the Open Market Desk at the Federal Reserve Bank of New York, uses repo transactions to implement monetary policy through the regulation of bank reserves. *Bankruptcy Reform: Hearing on S. 445 Before the Subcomm. on the Courts of the Senate Comm. on the Judiciary*, 98th Cong., 1st Sess. 310 (statement of Peter D. Sternlight, Executive Vice President of the Fed. Reserve

Bank of New York) [hereinafter *"Bankruptcy Reform Hearing"*]; *id.* at 339 (statement of Thomas W. Strauss, Chairman, Gov't. and Fed. Agency Sec. Div. of Public Sec. Ass'n); *SEC v. Miller,* 495 F. Supp. at 470-71); (J.A. 40). The Fed uses repos to add to bank reserves when it buys securities; conversely, when the Fed sells securities, it drains bank reserves. M. Stigum, *supra,* at 608; *Bankruptcy Reform Hearing, supra,* at 339 (statement of Thomas W. Strauss); *Bevill,* 67 B.R. at 567-68.

Repos are also utilized as a source of funding for government securities dealers. *SEC v. Miller,* 495 F. Supp. at 471; *Bankruptcy Reform Hearing, supra,* at 311 (statement of Peter D. Sternlight); *id.* at 340 (statement of Thomas W. Strauss); (J.A. 41-42). "Primary dealers" of U.S. government securities "rel[y] heavily on temporary financing through repo transactions with secondary dealers . . . and institutional customers pending resale of the issues to other investors." *Bevill,* 67 B.R. at 567; *Bankruptcy Reform Hearing, supra,* at 311 (statement of Peter D. Sternlight); (J.A. 42).

Repos also provide institutional investors with an opportunity to invest idle or surplus cash on a short-term basis. *SEC v. Miller,* 495 F. Supp. at 471; *Bankruptcy Reform Hearing, supra,* at 340 (statement of Thomas W. Strauss). "These investors include mutual funds [such as the Trusts], pension funds, state and local governments, commercial banks, thrifts, corporations, and other securities dealers. . . ." *Bankruptcy Reform Hearing, supra,* at 340 (statement of Thomas W. Strauss); *see Bevill,* 67 B.R. at 568.[6]

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[6] For additional information concerning repos and the repo market, *see generally Bevill,* 67 B.R. at 566-571; *SEC v. Miller,* 495 F. Supp. at 466-474; Note, 36 Am. U. L. Rev., *supra*; Note, *The Characterization of Repurchase Agreements in the Context of the Federal Securities Laws,* 61 St. John's L. Rev. 290 (1987); Note, *Repurchase Agreements and the Bankruptcy Code: The Need for Legislative Action,* 52 Fordham L. Rev. 828 (1984); Note, *Lifting the Cloud of Uncertainty Over the Repo Market: Characterization of Repos as Separate Purchases and Sales of Securities,* 37 Vand. L. Rev. 401 (1984).

2. In Tax Cases, the Legal Characterization of Repurchase Agreements is Determined by the Economic Substance of the Transaction.

"In cases where the legal characterization of economic facts is decisive, the principle is well established that the tax consequences should be determined by the economic substance of the transaction, not the labels put on it for property law (or tax avoidance) purposes." *Union Planters Nat'l Bank v. United States,* 426 F.2d 115, 118 (6th Cir.), *cert. denied,* 400 U.S. 827 (1970) [*"Union Planters"*] (*citing Commissioner v. P.G. Lake, Inc.,* 356 U.S. 260, 266-67 (1958)). "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Helvering v. F. & R. Lazarus & Co.,* 308 U.S. 252, 255 (1939).

In *Union Planters,* the Sixth Circuit considered the issue of whether coupon interest collected by a bank as the owner of municipal bonds subject to repurchase agreements was exempt from federal income taxation under I.R.C. § 103(a).[7] The bank purchased municipal

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[7] I.R.C. § 103(a) provides, in part, that "[g]ross income does not include interest on – (1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia;. . . ."

bonds from bond dealers, subject to agreements giving the bank the right to require the dealers to repurchase the bonds at any time at the price paid by the bank. The bank collected and retained interest on the bonds while holding the obligations, and on repurchase, the bank was credited with the pro rata interest accruing from the last coupon redemption date to the date of repurchase. 426 F.2d at 116. The bank asserted that, as it was the owner of the bonds and coupons, the interest income it received was exempt from federal income tax under § 103(a). The Government, however, contended the transactions were in reality loans secured by a pledge of the bonds. *Id.*

The Sixth Circuit rejected the lower court's finding that "'[t]he determination of this case required an inquiry into the intent of the parties.' . . . ," stating "[w]e do not agree that subjective intent is decisive here." 426 F.2d at 117. While noting that "[t]he intent of the parties may be important in determining just what their contractual relations *inter sese* were . . . ," the court stated the case "hinge[d], rather, on the legal characterization, for federal income tax purposes, of the transactions between the two parties. That characterization is not a question of fact, but rather one of law." *Id.* Following the principle that "tax consequences should be determined by the economic substance of [a] transaction", the court held "that [the] transactions, although characterized as sales-repurchases by the parties, [were to] be recognized as secured loans for federal income tax purposes, and that, accordingly, the bank, as economic lender, [could not] exclude the interest from its taxable income." *Id.* Crucial to the court's determination was the fact that the bank did not assume the risk of fluctuations in the market value of the

bonds associated with true ownership of the bonds. *Id.* at 117-18.

Consistent with the decision in *Union Planters*, other federal courts have treated repurchase agreements involving municipal bonds as secured loans, holding that the lender was not the owner of the underlying securities, and, therefore, did not receive interest income exempt from federal taxation under I.R.C. § 103(a). *First American Nat'l Bank v. United States*, 467 F.2d 1098, 1101 (6th Cir. 1972) (bank not entitled to exemption on interest earned on municipal bonds used in repos); *American Nat'l Bank v. United States*, 421 F.2d 447, 452-53 (5th Cir.), *cert. denied*, 400 U.S. 819 (1970) (same). *But see Citizens Nat'l Bank v. United States*, 551 F.2d 832, 843 (Ct. Cl. 1977) (economic substance of transaction found to be sale-repurchase where bank not required to resell bonds, and could sell bonds to third party and retain any profit due to market value).[8] The allocation of risk of market fluctuations in the price of the obligations is a major factor considered by

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[8] Federal court decisions construing § 103 recognize that allowing the buyer-lender to claim exemption for interest income under repos involving state and local obligations would avoid the effect of I.R.C. § 265(2) (now § 265(a)(2)), which disallows deductions for interest paid on indebtedness incurred to purchase or carry tax exempt obligations. *First American Nat'l Bank v. United States*, 467 F.2d at 1101; *Union Planters Nat'l Bank v. United States*, 426 F.2d at 116. As the Sixth Circuit stated in *First American Nat'l Bank*, 467 F.2d at 1101:

> [U]nder the arrangements described herein, . . . , the bank in effect is lending money to purchase bonds and is paying no tax on the interest received. Moreover, the person who purchases the bonds from the bank in effect borrows money to buy the bonds without paying interest. This results in the double tax benefit that Congress intended to prevent by enacting I.R.C. § 265(2).

the federal courts in determining the characterization of repos for federal income tax purposes. *First American Nat'l Bank v. United States*, 467 F.2d at 1102; *Union Planters Nat'l Bank v. United States*, 426 F.2d at 118; *American Nat'l Bank v. United States*, 421 F.2d at 451-52. "Only persons having the rights and incurring the risks that ownership of municipal bonds entails may treat the interest realized by them on the municipals as tax-exempt under section 103(a)(1)." *American Nat'l Bank v. United States*, 421 F.2d at 451.[9]

Under the view adopted by the court below, a different form of "double tax benefit" occurs if income derived from repos involving federal obligations is exempted from state taxation under § 3124. The seller-borrower would receive an exemption from state taxation for interest income received on the obligations. In addition, the Trusts, as the buyer-lender, would also receive an exemption from state taxation for income paid by the seller-borrower to the Trusts under the repo and passed on to the Trusts' shareholders. Section 3124 should not be construed to require an exemption for both the party who owns federal obligations and receives the interest income paid on such obligations, and to also require exemption from state taxation of income paid by the seller-borrower to the Trusts derived from their loans secured by federal obligations.

[9] The Internal Revenue Service has identified several factors indicating that a repurchase transaction constitutes a secured loan, and not a sale of securities. I.R.S. Rev. Rul. 74-27, 1974-1 C.B. 24. Among the factors indicative of a loan are: (1) whether the seller can require the purchaser to resell the securities, and whether the identical securities are bought and sold; (2) whether the purchaser can require the seller to repurchase the securities; (3) whether the agreement provides for a specific remedy in the event of default by either party; (4) whether the seller agrees to pay interest at a stipulated rate between sale and resale; and (5) whether the amount advanced does not necessarily equal the value of the securities sold. *Id. See also* I.R.S. Rev. Rul. 82-144, 1982-2 C.B. 34 (purchaser of municipal obligations

State courts have relied on these federal court precedents construing the exemption under I.R.C. § 103(a) in holding that, based on the economic substance of the transaction, income derived from repos involving federal obligations is not exempt from state taxation. *See, e.g., Comptroller v. First United Bank*, 320 Md. 352, 373-75, 578 A.2d 192, 202-203 (1990); *Department of Revenue v. Page*, 541 So. 2d 1270, 1273-75 (Fla. Dist. Ct. App. 1989); *Andras v. Dept. of Revenue*, 154 Ill. App. 3d 37, 42-45, 106 Ill. Dec. 732, ___, 506 N.W.2d 439, 443-44 (1987), *cert. denied*, 485 U.S. 960 (1988). *See also Everett v. Dept. of Revenue*, 470 N.W.2d 13, 15 (Iowa 1991) (*citing Andras v. Dept. of Revenue* and *Department of Revenue v. Page*); *Massman Const. Co. v. Director of Revenue*, 765 S.W.2d 592, 595 (Mo. 1989) (stating court "reserve[d] the right to characterize the substance of transactions without regard to their form, when precise distinctions are legally significant."); *In re Thomas Sawyer Estate*, 149 Vt. 541, 545, 546 A.2d 784, 786 (1987) (*citing American Nat'l Bank v. United States*); *Capital Preservation Fund, Inc. v. Dept. of Revenue*, 145 Wis. 2d 841, 847-48, 429 N.W.2d 551, 554-55 (Wis. Ct. App. 1988) (*citing Andras v. Dept. of Revenue*). While the question presented concerns a state's taxation of income derived from repurchase agreements involving federal obligations, no principled reason exists to ignore the Court's long-standing view that tax consequences should be based on "substance and realities",

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deemed owner entitled to exempt interest income notwithstanding purchase of "put" agreements providing taxpayer option or right to require seller to repurchase obligations).

Helvering v. F. & R. Lazarus & Co., 308 U.S. at 210, and not mere form.[10]

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[10] Petitioner acknowledges that the characterization of repos may differ based on the context in which such transactions are analyzed. Whether a repo is deemed a secured loan or a purchase and sale depends on the context in which the characterization is made. Note, 61 St. John's L. Rev., *supra*, at 309 n.98.

In the context of the bankruptcy laws, courts generally characterized repos as purchase and sale securities transactions rather than as secured loans. *Bevill*, 67 B.R. at 598 (repo agreements "contracts for the sale of securities and their resale back to the original seller at a future date"); *Financial Corp. v. Occidental Petroleum Corp.*, 634 F.2d 404, 404-05 (8th Cir. 1980) (one week repurchase transaction held a sale and agreement to repurchase); *Gilmore v. State Bd. of Admin.*, 382 So. 2d 861, 863 (Fla. Dist. Ct. App. 1980) (repos treated as purchase and sale in bond transaction). *In re Lombard-Wall, Inc.*, No. 82 B 1156 (Bank. S.D.N.Y. Sept. 16, 1982), however, held that a repo constituted a secured loan and the securities merely collateral. Under this ruling, the automatic stay provisions of the Bankruptcy Code barred repo purchasers from liquidating securities in the event a seller filed for bankruptcy prior to the repurchase date. The decision in *Lombard-Wall* caused considerable concern in the securities industry and on the part of the Federal Reserve over the continued liquidity and safety of the repurchase market. *See generally Bankruptcy Reform Hearing, supra*. Congress responded to *Lombard-Wall* by enacting § 559 of the Bankruptcy Code (11 U.S.C. § 559). Section 559 effectively neutralized the adverse consequences raised by the *Lombard-Wall* decision by granting purchasers of securities under repos the right to liquidate the securities immediately upon a seller's bankruptcy. Any proceeds from the sale of securities in excess of the agreed repurchase price, however, are deemed property of the estate.

In the context of the securities laws, the trend in cases brought under the anti-fraud provisions of Section 10(b) of the Securities and Exchange Act of 1934 has been to treat repos as

3. The Economic Substance of a Repurchase Transaction is that of a Collateralized Loan, and Not a Purchase and Sale of the Underlying Federal Obligations.

It is generally recognized that the economic substance of a repurchase agreement supports a secured loan characterization. *SEC v. Miller*, 495 F. Supp. at 467; M. Stigum, *supra*, at 577 ("*economic essence* of the transaction is that it is a *collateralized loan*"); *see First American Nat'l Bank v. United States*, 467 F.2d at 1101; *Union Planters Nat'l Bank v. United States*, 426 F.2d at 118; *United States v. Erickson*, 601 F.2d 296, 300 n.4 (7th Cir.), *cert. denied*, 444 U.S. 979 (1979). "The seller retains many attributes of

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"purchases and sales" of securities. *SEC v. Drysdale Securities Corp.*, 785 F.2d 39, 42-43 (2d Cir.), *cert. denied*, 476 U.S. 1171 (1986) (alleged misrepresentations made with respect to financial condition of company involved in repo market in federal government obligations made in connection with purchase or sale of securities for purposes of Act's prohibition against fraudulent conduct in connection with purchase and sale of securities). Certain policy factors underlying the Securities and Exchange Act, including broadly construing the terms "purchase" and "sale" to effectuate the Act's remedial purpose and considering whether a sale characterization will advance the purposes of the Act, are considered in determining the characterization of repos in the securities law context. *First Nat'l Bank of Las Vegas v. Estate of Russell*, 657 F.2d 668, 676 (5th Cir. 1981). Indeed, the Court has held that a "pledge" of securities transferring a security interest may constitute a "purchase or sale" of securities for purposes of the federal securities laws. *Rubin v. United States*, 449 U.S. 434, 428-30 (1981).

The fact that repos may be categorized differently for purposes other than taxation in the bankruptcy and securities law (or other) contexts should not alter the test to be employed in determining the legal characterization of repos for tax purposes.

ownership and most terms of the agreement are more typical of a secured loan than a sale." Note, 52 Fordham L. Rev., *supra*, at 837.

First, the absence of exposure to risk of price fluctuations in the market value of the obligations strongly indicates that ownership remains with the seller-borrower. The seller-borrower's "obligation to repurchase the securities at a specified price insulates the buyer from any risk of market fluctuations." Note, 52 Fordham L. Rev., *supra*, at 837-38; *see American Nat'l Bank v. United States*, 467 F.2d at 1101; *Union Planters Nat'l Bank v. United States*, 426 F.2d at 118.

The price structure of the transaction is also indicative of a secured loan. While, in a sale of securities, the price is generally the fair market value, the market value of securities subject to a repo generally exceeds the purchase price. *SEC v. Miller*, 495 F. Supp. at 469-70; M. Stigum, *supra*, at 580. The difference between the market price of the securities and the amount of money transferred serves as a "margin" to insulate the buyer-lender against adverse market shifts should the buyer-lender be forced to liquidate the security in the event of default. *SEC v. Miller*, 495 F. Supp. at 469; M. Stigum, *supra*, at 580.[11] The establishment of the repurchase price also supports a secured loan characterization. While, in a sale transaction, the price would be based on expectations as to future market price, in a repo, the repurchase price is

[11] The differential between the market value of the securities and the sale price is referred to in the trade as the "haircut". *Bevill*, 67 B.R. at 567, M. Stigum, *supra*, at 580.

the initial sale price. M. Stigum, *supra*, at 576 ("seller buys back the asset at the same price at which he sold it", plus "interest"). Thus, the pricing structure of a repo is indicative of a loan and not a sale.

Repos also usually contain a "mark-to-market" provision giving the buyer-lender the right to require the seller-borrower to transfer additional securities if the market value of the original securities declines below a certain level. *SEC v. Miller*, 495 F. Supp. at 470; Note, 52 Fordham L. Rev. at 839. This provision, intended to further insulate the buyer-lender from risk of loss upon default, "is characteristic of a secured loan, but inconsistent with a sale." Note, 52 Fordham L. Rev., *supra*, at 839.

The retention by the seller-borrower of the right to retain interest earned on the underlying obligations during the period of the repo also indicates that a repo is properly categorized as a loan and not a sale. *SEC v. Miller*, 495 F. Supp. at 467 (parties to repo "customarily provide that any interest accruing on the securities between the dates of the initial purchase and subsequent 'repurchase' remains the borrower's property"). Moreover, while the buyer-lender, in the event of default by the seller-borrower, has the right to sell the securities, repos customarily provide that any excess of the liquidation price above the repurchase price must be paid to the seller-borrower by the buyer-lender. Note, 52 Fordham L. Rev., *supra*, at 840. "Such a transfer of sale proceeds is hardly consistent with the characterization of the buyer-lender as owner of the securities. Rather, this disposition of sale proceeds is typical of a secured transaction with the holder of collateral seeking to satisfy a secured claim." *Id.*

Several state courts have upheld the taxation of income realized by business trusts resulting from

repurchase agreements involving federal obligations, recognizing that, despite the parties' characterization of the transactions as constituting a sale and repurchase, the transactions are, in substance, secured loans in which the obligations serve as collateral. *Everett v. Dept. of Revenue*, 470 N.W.2d at 14-15 ("repurchase agreements, despite their name, are actually secured loans"); *Comptroller v. First United Bank*, 320 Md. at 367-75, 578 A.2d at 200-203 ("the substance of the transaction for tax purposes is a loan by the trust to the seller-borrower, secured by the pledge of government obligations"); *Department of Revenue v. Page*, 541 So. 2d at 1275 ("Trust does not have the risks or rights associated with ownership", and thus is "not the true owner of the federal obligations under the repurchase agreements"); *In re Thomas Sawyer Estate*, 149 Vt. at 545, 546 A.2d at 786 ("[w]hen holding federal obligations as part of a repurchase agreement, the Trust holds them, in essence, as security for a loan to the original purchase of the federal obligations"); *Capital Preservation Fund, Inc. v. Dept. of Revenue*, 145 Wis. 2d at 847, 429 N.W.2d at 554 (interest paid to Trust "not interest on the transferred and retransferred government securities, but rather is the equivalent of interest on the Trust's 'loan' to the bank"); *Andras v. Dept. of Revenue*, 154 Ill. App. 3d at 44, 106 Ill. Dec. at ___, 506 N.E.2d at 444 ("the Trusts accepted none of the risks of ownership, and we therefore conclude that the transactions were secured loans rather than sales").[12]

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[12] The "Trust" involved in each of these cases was the Trust for Short-Term U.S. Government Securities. *Everett v. Dept. of Revenue*, 470 N.W.2d at 13; *Comptroller v. First United Bank*, 320 Md. at 354, 578 A.2d at 193; *Department of Revenue v. Page*, 541 So. 2d at 1270; *In re Thomas Sawyer Estate*, 149 Vt. at 542, 546 A.2d at 784; *Capital Preservation Fund, Inc. v. Dept. of Revenue*, 145 Wis. 2d at 842, 429 N.W.2d at 552; *Andras v. Dept. of Revenue*, 154 Ill. App. 3d at 38, 106 Ill. Dec. at ___, 506 N.E.2d at 440. This is one of the two Trusts invested in by Loewenstein. (J.A. 3-4; 61).

An examination of the "General Repurchase Agreement" typically used by the Trusts when engaging in repos illustrates that, in economic substance, the transactions were loans by the Trusts to the seller-borrowers in which the federal obligations functioned as collateral (J.A. 65-71). The Agreement is a master contract providing terms under which the Trusts, registered investment companies (referred to as the "Fund") engaged in repos with seller-borrowers, referred to as the "Seller". The subject matter of the repos is "obligations issued or guaranteed by the United States Government or agencies thereof, ('Eligible Securities')." (J.A. 65). The "Sale Price" is the initial sale price as agreed to by the parties. The repurchase price, to be paid by the seller-borrower on a specified date or on demand by either party, is the "Sale Price" "plus interest at the agreed upon interest rate ('Interest Rate')." (J.A. 65-66).

The initial step in a repo transaction consists of the Seller transferring the "Eligible Securities" to the Fund's "Custodian", and the Trust causing the "Sale Price" to be credited to the account of the Seller in immediately available funds. (J.A. 66). During the repo period, the seller-borrower must maintain on a daily basis a margin of at least 102 percent of the sale price in "Eligible Securities" with the "Custodian". (J.A. 66, 69-70). The market value of the securities is determined by the bid quotations on

the immediately preceding business day, plus accrued interest on the obligations. (J.A. 66).

The seller-borrower has the right under the Agreement to withdraw securities transferred to the Custodian and to substitute other "Eligible Securities" of a value sufficient to maintain the required margin. (J.A. 68).[13] If the seller-borrower satisfies the margin requirements, the Trusts also agree "to pay over to Seller as soon as received all principal, interest and other sums paid by or on behalf of the issuer in respect to the Securities and collected by the [Trusts]. . . . " (J.A. 69). If the seller-borrower fails to maintain margin, the Trusts "may retain any such sums as Cash Collateral. . . . " (J.A. 69). If the market value of the Eligible Securities, plus any Cash Collateral, exceeds the margin percentage, the seller-borrower may require the Trusts to pay the excess to the seller-borrower. (J.A. 70).

Failure of the seller to repurchase on time constitutes an event of default, as are the seller's misrepresentation of its financial condition or the seller's filing for relief under the bankruptcy laws. (J.A. 71-72). Upon payment by the seller of the Sale Price plus Interest, "the [Trusts] agree[ ] to resell such securities and pay over all principal, interest and other sums paid by or on behalf of the

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[13] In contrast, the Agreement contains no provision allowing the Trusts to obtain the Eligible Securities from the Custodian, or permitting the Trusts to transfer or sell such securities for their own accounts, absent a default by the seller-borrower. (J.A. 73). Indeed, the Trusts "agree[ ] that [they] will not resell or register the Securities unless an event described in paragraph 13 [Seller Events of Default] shall have occurred." (J.A. 69).

issuer in respect thereof collected by the [Trusts]" not previously paid over to the seller-borrower. (J.A. 66).

The Agreement also provides that "in the event that a repurchase transaction hereunder is deemed not to be a sale" the "Seller shall be deemed to have hereby granted to the [Trusts] a first security interest in and lien upon, and to have pledged the Cash Collateral and Securities." The Agreement also provides that "[n]otwithstanding the foregoing sentence, it is the intention of the Seller and the [Trusts] that each such transaction shall be a 'sale' within the meaning of the New York Uniform Commercial Code." (J.A. 78).

In *Comptroller v. First United Bank*, 320 Md. 352, 578 A.2d 192, the Court of Appeals of Maryland reviewed the provisions of a "master repurchase agreement" virtually identical to that utilized by the Trusts.[14] Finding that, "[a]lthough the transaction [was] in form a sale and repurchase, and despite the intention of the parties to effect a sale", the court found "the substance of the transaction for tax purposes is a loan by the Trust to the seller-borrower, secured by the pledge of government obligations." *Id.* at 371, 578 A.2d at 201. The court noted the following characteristics of the transaction leading to the conclusion that the repurchase transactions constituted secured loans:

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[14] The identity of the two agreements is evident upon comparison of the Maryland court's discussion of the "master repurchase agreement" (320 Md. at 368-70, 578 A.2d at 200) and the "General Repurchase Agreement" attached to the Second Stipulation of Facts in this case (J.A. 65-81).

As step one 'purchaser', the Trust does not bear the risk of fluctuations in the market value of the United States obligations as would an owner of the securities. The repurchase price is fixed at the first step and remains uninfluenced by subsequent market events. Nor is the price paid for the securities at step one intended to be market value, as might be expected in a purchase of securities. Under the margin requirements, market value must be at least 102% of the sale price.

The seller-borrower is also required to post additional securities if the minimum margin requirements are not maintained. This strongly indicates that the transfer of government obligations to the Custodian is to secure the seller-borrower's promise to repurchase, *i.e.*, to repay the funds used by the seller-borrower plus interest at the agreed rate. That indication is reinforced by the default provisions. Upon the seller-borrower's failure to repurchase when promised, the Trust may sell the obligations, and any excess sales proceeds over the amount of the seller-borrower's obligations are paid to the seller-borrower. Were the Trust the owner of the securities, the proceeds of a sale would be the Trust's.

Furthermore, during the term of the repo, income produced by the government obligations is applied to the benefit of the seller-borrower, either as cash collateral, if required, and if not, then payable to the seller-borrower from time to time or at termination. An owner by purchase of the securities would be entitled to the income.

Id. at 371-72, 578 A.2d at 201.

In addition to the decision of the Maryland Court of Appeals in *Comptroller v. First United Bank*, virtually every other state court addressing the issue has concluded that income from repos involving federal securities distributed to mutual fund shareholders is not exempt under § 3124, as the economic reality of the transaction is that the securities merely serve as collateral for what is in economic effect a loan by the Trusts to the seller-borrower, and the Trusts do not receive interest income from the securities, but, rather, are paid "interest" on the loan by the seller-borrower at the rate agreed to by the parties.[15] "[T]he decisions of the state courts, particularly if

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[15] *Everett v. Dept. of Revenue*, 470 N.W.2d at 14-15; *Department of Revenue v. Page*, 541 So. 2d at 1275; *In re Thomas Sawyer Estate*, 149 Vt. at 545, 546 A.2d at 786; *Capital Preservation Fund, Inc. v. Department of Revenue*, 145 Wis. 2d at 849, 429 N.W.2d at 554; *Andras v. Dept. of Revenue*, 154 Ill. App. 3d at 45, 106 Ill. Dec. at ___, 506 N.E.2d at 444. In addition, state courts applying similar reasoning have upheld state taxation of income derived from repos received by taxpayers engaging directly in repo transactions, as opposed to income received by shareholders of mutual funds. *Hammond Lead Products, Inc. v. Tax Com'rs*, 575 N.E.2d 998 (Ind. 1991) (taxpayer "did not own the securities" and, therefore, not entitled to exemption) (*distinguished Department of Revenue v. Hardware Wholesalers, Inc.*, 622 N.E. 2d 930, 934 (Ind. 1993) (fund transactions between taxpayer and bank under repurchase agreements not "deposits" exempt from intangibles tax); *Massman Const. Co. v. Director of Revenue*, 765 S.W.2d at 594-95. *See also Borg v. Dept. of Revenue*, 308 Or. 34, 39, 774 P.2d 1099, 1102 (1989) (income from Trust's dealings in repurchase agreements not exempt, as income paid by seller and not "interest" paid by United States on obligations). A Michigan appellate court concluded that shares in a mutual fund which invested in federal obligations were exempt from an intangibles tax, without discussing the repo issue. *Matz v. Dept. of Treasury*, 155 Mich. App. 778, 401 N.W.2d 62 (1986). While *Matz* is not persuasive

they are uniform and concur in their reasoning, are worthy of respectful consideration, even if the question be, at last, a Federal one." *Plummer v. Coler*, 178 U.S. 115, 120 (1900). The reasoning employed by these courts is compelling, and should be adopted by this Court. The Trusts, for tax purposes, do not own the federal securities which, in economic substance, serve as collateral for loans by the Trusts to the seller-borrowers. The interest earned by the Trusts is not interest paid by the federal government on the obligations; rather, the income earned by the Trusts is the "interest" paid by the seller-borrowers on repurchase.

4. Nebraska Does Not "Consider" U.S. Government Obligations or Interest on Such Obligations in Computing its Tax on Income Distributed to Mutual Fund Shareholders Derived from Repurchase Agreements.

The court below, while not finding that the Trusts directly owned federal obligations under their repurchase agreements, nevertheless held the state's tax on income from repos received by the Trusts and distributed to Loewenstein

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authority simply because of its absence of any analysis of the issue, it has also been distinguished in a later Michigan case, *H.J. Heinz Co., Inc. v. Dept. of Treasury*, 197 Mich. App. 210, 215, 494 N.W.2d 850, 853 (1992), where the court stated that it "agree[d] with those courts which classify repo transactions as collateralized loans rather than as purchases and sales." The state court majority opinion did not directly address the issue, stating "[w]e do not believe that direct ownership determines whether income from a repo agreement is exempt under § 3124." (Pet. Cert. App. A-12).

violated § 3124 because "the income received by" Loewenstein was, "at the very least, considered indirectly in the computation of the tax." (Pet. Cert. App. A-13).[16] This conclusion simply cannot be squared with the language of § 3124, or this Court's decisions construing the scope of the exemption required by the statute.

31 U.S.C. § 3124 provides, in pertinent part:

> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both to be considered in computing a tax. . . .

Section 3124 is a revision and recodification of Rev. Stat. § 3701, as amended, 31 U.S.C. § 742 (1976). Section 3701, as amended, provided, in part:

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[16] The manner in which the state court phrased its finding is admittedly confusing. Obviously, the "income" received by Loewenstein was "considered . . . in the computation of the tax", as the tax at issue is Nebraska's individual income tax. Undoubtedly, what the court below meant was that, in the majority's view, Nebraska's taxation of the income distributed to Loewenstein violated § 3124 because the income he received was based on consideration of federal obligations or interest on such obligations. This is the view urged by Respondent. (Brief in Opp. to Petition at 11-12) ("The economic reality is that whatever income the Trusts derive from these transactions arises in consideration of the federal obligations that are subject to the transaction."). As will be discussed at pages 34-40, *infra*, this interpretation is at odds with the scope of the exemption under § 3124.

> [A]ll stocks, bonds, Treasury notes and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax,. . . .

Title 31 of the United States Code was not enacted into positive law until 1982, when it was reformulated "without substantive change." *See* Act of Sept. 13, 1982, Pub. L. No. 97-258, § 4(a), 96 Stat. 877, 1067. Since the recodification did not substantively change the statute, decisions construing § 742 are binding authority in the construction of § 3124.

The Court has "treated [§ 3124] as principally a restatement of the constitutional rule [that federal government property is immune from state taxation.]" *Memphis Bank & Trust Co. v. Garner,* 459 U.S. 392, 397 (1983). "The 1959 addition to § 3701 did not broaden the scope of the exemption required by § 3701 beyond that mandated by the Constitution. . . . " *First Nat'l Bank of Atlanta v. Bartow Cty. Bd. of Assrs.*, 470 U.S. 583, 593 (1985). The exemption for federal obligations provided by § 3701, as amended, has been recognized as "sweeping: with specific exceptions, it 'extends to *every form* of taxation that would require that either the obligations or the interest thereon, or both, *be considered, directly or indirectly, in the computation* of the tax' (emphasis supplied)." *American Bank and Trust Co. v. Dallas County,* 463 U.S. 855, 862 (1983) (*citing Memphis Bank & Trust Co. v. Garner,* 459 U.S. at 395-96). "Under the plain language of the 1959 amendment . . . the tax is barred regardless of its *form* if federal

obligations must be considered, either directly or indirectly, in *computing* the tax." *American Bank and Trust Co. v. Dallas County,* 463 U.S. at 862 (emphasis in original). "The tax exemption required by the Constitution and § 3701 is not a tax shelter." *First Nat'l Bank of Atlanta v. Bartow Cty. Bd. of Assrs.*, 470 U.S. at 597.

American Bank and Trust Co. v. Dallas County involved a Texas property tax on bank shares. The tax "was computed by use of an 'equity capital formula' which involved determining the amount of the bank's capital assets, subtracting from that figure the bank's liabilities and the assessed value of the bank's real estate, and then dividing the result by the number of shares." 463 U.S. at 862-63. The Court determined the tax took "into account, at least indirectly, the federal obligations that constitute[d] a part of the bank's assets." *Id.* at 863. The Court further stated that, "[g]iving the words of amended § 3701 their ordinary meaning, there can be no question that federal obligations were considered in computing the bank shares tax at issue here. In context, the word 'considered' means taking into account, or included in the accounting." *Id.* at 862 (footnote omitted). Finding that § 3701 "prohibit[ed] any form of tax that would require consideration of federal obligations in computing the tax", *id.* at 865, the Court held the bank shares tax "violated the plain language of § 3701." *Id.*

American Bank and Trust Co. v. Dallas County confirms that § 3124 extends only to forms of state taxation which "consider" U.S. obligations or the "interest" on such obligations "in computing [the] tax." Neither federal securities, nor the interest on federal securities, were considered in the computation of Nebraska's tax on

income distributed from the Trusts to Loewenstein derived from repurchase agreements. In a repurchase transaction, the federal obligations are not actually owned by the Trusts, but are taken as security for what is, in economic effect, a loan by the Trusts to the seller-borrower/repurchasers. The obligations themselves are not "taken into account" or "included in the accounting" (*American Bank and Trust Co.*, 463 U.S. at 862) in the computation of the tax, as the measure of the tax has nothing to do with the value of the federal obligations. Moreover, the "interest" received by the Trusts is not the interest paid by the federal government on the obligations, but, rather, is interest paid by the seller-borrower/repurchasers at the rate agreed to by the parties as part of the repo agreement. The "interest" income received by the Trusts was paid by the seller-borrower/repurchasers, not the federal government.

Addressing the same issue presented in this case, the Supreme Court of Iowa stated:

> The United States Constitution Article VI clause 2 and 31 U.S.C. § 3124(a) prohibit any form of state taxation which requires an obligation of the United States Government or the interest thereon to be considered in computing a tax. Here the interest was not on the federal obligations but on the repo agreements; it was paid not by the federal government, but by the seller-repurchasers. Moreover, it was those seller-repurchasers, not the federal government, that set the interest rate to be paid under the repurchase agreements, and indeed the interest rates paid pursuant to the repo's were different from those paid on the federal obligations.

> The State's tax did not consider, either directly or indirectly, the federal obligations or the interest paid on them in calculating the Everetts' tax. Instead, the tax was based on the interest paid by private seller-repurchasers pursuant to a private sector loan agreement in which federal obligations served as collateral. In such a situation, neither the federal obligations nor the interest thereon is considered in calculating the state income tax. . . . [N]either the supremacy clause nor 31 U.S.C. section 3124(a) prevents the State from taxing the income derived from the repurchase agreements.

Everett v. Dept. of Revenue, 470 N.W.2d at 15. *Accord In re Thomas Sawyer Estate*, 149 Vt. at 545, 546 A.2d at 786 ("[w]hile the repurchasing agreements nominally involve federal obligations, the profits derived therefrom are not interest income attributable to the federal obligations"; "[t]he income gained by the Trust from these arrangements is therefore interest income on the loan the Trust provides the seller, rather than interest income derived from the federal obligation, and is not exempt from state taxation under § 3124(a)."); *Borg v. Dept. of Revenue*, 308 Or. at 39, 774 P.2d at 1102 (repo "income is not paid by the United States or other issuer but by the seller at the time of repurchase. It is not 'interest' paid by the United States, which in fact may pay no interest to anyone during the period between sale and purchase"); *Hammond Lead Products, Inc. v. Tax Com'rs*, 575 N.E.2d at 1001 ("the interest on the U.S. obligations, paid by the U.S. government to the Bank, was not taxed by the State. Hammond Lead received interest income pursuant to its agreement with the Bank and was properly taxed").

In *First Nat'l Bank of Atlanta v. Bartow Cty. Bd. of Assrs.*, the Court held that § 742 did not require a state to allow a bank to deduct the full value of its federal securities from its gross assets in computing a bank shares tax. The Court recognized that, because the bank may have incurred liabilities, the interest on which was also deductible, to acquire the securities, the statute was satisfied by the state's allowing only a pro-rata deduction from the bank's net worth for the securities. The Court concluded that the bank should not be permitted to use the federal obligations to "shelter taxable income." 470 U.S. at 595. Similarly, in this case, Loewenstein should not be allowed to "shelter" taxable income distributed by the Trusts, which income results not from the Trusts ownership of federal securities, but, rather, from the Trusts loan of funds to seller-borrowers which is repaid with interest. Section 3124 does not require that either the Trusts or Loewenstein be permitted to shelter from Nebraska's tax income in the form of interest paid to the Trusts by seller-borrowers under repurchase agreements secured by federal securities.

Neither the plain language of § 3124 nor the history of the 1959 amendment indicates that Congress intended to accomplish anything other than to abandon formalistic distinctions between acceptable and unacceptable forms of state taxation of federal obligations and interest paid on such obligations. As the Court stated in *First Nat'l Bank of Atlanta v. Bartow Cty. Bd. of Assrs.*, Congress, by enacting the 1959 amendment, "intended to abolish the formalistic distinction between taxes **on** income and taxes **measured by** income . . . [N]othing in the legislative history indicate[s] that Congress understood the addition

to broaden the scope of the exemption, as well as to clarify the form of taxes to which the exemption applied." 470 U.S. at 594 (emphasis in original).[17] The exemption asserted by Loewenstein is far removed from the concerns articulated by Congress in adopting the 1959 amendment. The income subject to Nebraska tax in this case is, in substance, interest paid by private party seller-borrower/repurchasers on loans which used federal obligations as collateral. Simply put, the tax imposed did not "consider" U.S. obligations in its computation, nor did it "consider" interest paid on such obligations. Consequently, Nebraska's tax does not violate § 3124.

Section 3124, by its terms, is directed only at forms of state taxation which "consider" U.S. government obligations or the interest on such obligations "in computing [the] tax". Both the court below and Loewenstein misconstrue the plain language and intent of the statute to mandate exemption of "income" derived from transactions "in consideration of federal obligations." Brief in Opp. to Petition at 11-12. The statute, however, speaks only in terms of prohibiting taxes which, in their computation, consider the obligations or the interest paid by the federal government on the obligations; it says nothing about state taxation of income resulting from commercial

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[17] The Court noted that the "catalyst" for the 1959 amendment was an Idaho statute imposing a tax on individuals "according to and measured by [their] income." Idaho had taken the position that, while states could not tax income received on federal obligations, it was not required to exempt income received on federal obligations from "gross income" from which taxable net income was derived. *First Nat'l Bank of Atlanta v. Bartow Cty. Bd. of Assrs.*, 470 U.S. at 594.

transactions which, at most, only peripherally involve such obligations or interest. Indeed, Loewenstein's argument, taken to its logical conclusion, would require states to exempt from taxable income interest earned on direct loans between private parties secured by federal securities. Such a construction of § 3124 is plainly untenable.[18]

B. Nebraska's Taxation of Income of Shareholders of Mutual Funds Derived from Repurchase Agreements Does Not Diminish the Marketability of Federal Securities and Does Not Impair the Borrowing Ability of the United States.

In finding that Nebraska's taxation of repo income distributed by the Trusts to Loewenstein violated § 3124, the court below found that the state's tax "clearly impose[d] a burden on the market for federal securities." (Pet. Cert. App. A-13). Relying on the deposition testimony of Peter D. Sternlight, executive vice president of the Federal Reserve Bank of New York, the majority

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[18] Indeed, even if Loewenstein is correct in his claim that the repos engaged in by the Trusts should be recognized as actual sales and repurchases of federal obligations, under which the Trusts actually owned the securities, Nebraska's tax would only constitute a tax on income derived from the gain on sale of the federal obligations. Interest paid by the United States on federal obligations is the only form of income exempt from state taxation under § 3124. There is no requirement that a state exempt income received based on gain realized from the sale of federal obligations. *See Willcuts v. Bunn*, 282 U.S. 216, 227-30 (1931) (upholding federal taxation of gain on sale of state obligations); Brief of Amici Curiae States of California, et al. at 13-17.

concluded "that a state tax on such income would diminish the market value and the investment attractiveness of federal securities, that the tax would impose a burden on the federal government's regulation of the nation's money supply, and that such tax would increase the costs to the federal government in financing the national debt." *Id.* The record simply does not support this conclusion.

Section 3124 is "principally a restatement of the constitutional rule [that federal government property is immune from state taxation.]" *Memphis Bank & Trust Co. v. Garner*, 459 U.S. at 397. "The 1959 addition to § 3701 did not broaden the scope of the exemption required by § 3701 beyond that mandated by the Constitution. . . . " *First Nat'l Bank of Atlanta v. Bartow Cty. Bd. of Assrs.*, 470 U.S. at 593. One of the principal purposes of the intergovernmental tax immunity doctrine is to prevent "States from taxing federal obligations in a manner which has an adverse effect on the United States' borrowing ability." *Rockford Life Ins. Co. v. Dept. of Revenue*, 482 U.S. 182, 190 (1987). "[T]he long established congressional intent [of § 3124 is] to prevent taxes which diminish in the slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure the necessary credit." *Smith v. Davis*, 323 U.S. 111, 117 (1944). The intent of the statute, however, is "to immunize from state taxation only the interest-bearing obligations of the United States needed to secure credit to carry on the necessary functions of government. That intent . . . should not be expanded or modified in any degree by the judiciary." *Id.* at 119. *See also Rockford Life Ins. Co. v. Dept. of Revenue*, 482 U.S. at 191-92 (noting Court's observation in *Smith v. Davis* as to scope of the statutory immunity for federal obligations is "relevant to

our role in applying the constitutional doctrine as well. . . . ").[19]

A review of the Sternlight deposition reveals that Mr. Sternlight expressed no opinion as to the effect of state taxation of income from repos involving federal obligations.[20] The substance of his testimony is contained in his

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[19] The court below referred to the language in *Smith v. Davis* regarding congressional intent "to prevent state taxes which diminish in the **slightest degree** the market value or investment attractiveness of obligations issued by the United States in an effort to secure necessary credit. (Pet. Cert. App. A-12) (emphasis in original). It is important to note, however, the context in which the Court expressed this view in *Smith v. Davis*. At issue in *Smith v. Davis* was whether § 3701, the predecessor to § 3124, precluded a state property tax assessed on the value of an open account claim against the United States. The Court concluded that § 3701 did not prohibit the tax because the open account claim was not within the class of "other obligations" exempted under § 3701. 323 U.S. at 116-119. Thus, the language in *Smith v. Davis* referred to by the court below related to the Court's definition of the scope of the term "other obligations" under the immunity statute. This passage does not, as suggested by the court below, indicate that the Court has established a broad construction of § 3124 which bars any state tax which has any effect, however remote, which could diminish the value or investment attractiveness of federal obligations. The Court in *Smith v. Davis* simply defined the nature of the obligations exempted by the statute. Indeed, the Court's decision supports a reading of § 3124 which does not unduly expand the exemption required by the statute to matters beyond those encompassed by its terms. *Id.* at 117 ("[t]ax exemptions being the exception rather than the rule, much clearer language evidencing an intent to immunize open account claims under Section 3701 is necessary. . . . ").

[20] Mr. Sternlight's deposition was part of the evidence before the Florida court in *Department of Revenue v. Page*, 541 So. 2d 1270. (J.A. 22).

affidavit, attached to the deposition (J.A. 39-44). This affidavit was submitted by Mr. Sternlight in the bankruptcy proceedings involving Bevill, Bresler & Schulman Asset Management Corporation (J.A. 39); *Bevill*, 67 B.R. at 565 (referring to Sternlight affidavit).

The adverse consequences to the repo market which could result from failure to recognize repos as constituting true sales and repurchases of the underlying obligations, articulated in Mr. Sternlight's affidavit, were expressed in the context of the Federal Reserve's concern as to the characterization of repos for bankruptcy law purposes. *In re Lombard Wall* held that repos constituted secured loans and the securities were merely collateral. Thus, under the automatic stay provisions of the Bankruptcy Code, repo purchasers were barred from liquidating securities in the event a seller filed for bankruptcy prior to the repurchase date. *Lombard Wall* caused considerable concern in the securities industry and on the part of the Federal Reserve over the continued liquidity and safety of the repurchase market. *See generally Bankruptcy Reform Hearing, supra*. Mr. Sternlight testified before the Senate Subcommittee on the Courts of the Senate Committee on the Judiciary during the Bankruptcy Reform Hearing. Noting the various purposes for which repos were used by the Federal Reserve, government securities dealers, and investors, he testified as to the concerns of the Federal Reserve should repos be treated as secured loans rather than sales for bankruptcy purposes:

> The common element in all these extensive uses of repo agreements is liquidity. Without that characteristic, the repurchase agreement would not serve the function that it now does. As you

know, recent developments have threatened the liquidity of the market – namely, by raising the possibility that the automatic stay provisions of the Bankruptcy Code may be applied to an investor's holdings of securities under a repo. A holder who would not be able to meet his contract at maturity would clearly have his liquidity impaired. This possibility has raised uncertainties among repo market participants, and has caused some to curtail their operations or even withdraw entirely from the market. The total effect is not yet severe for the overall market, but has the potential for becoming so.

Bankruptcy Reform Hearing, supra, at 306.

Mr. Sternlight also submitted a prepared statement to the Subcommittee. *Id.* at 310-315. A comparison of this statement and the contents of the affidavit in evidence in this case reveals that many of the statements contained therein are similar or virtually identical. Both Mr. Sternlight's statement to the Subcommittee and his affidavit in the *Bevill* case are directed toward the Federal Reserve's concerns over the treatment of repos for bankruptcy law purposes; they make no mention of any concern due to state taxation of repo income. Indeed, Mr. Sternlight, in a written response to the inquiry of the Chairman of the Committee on the Judiciary of the U.S. House of Representatives as to whether the proposed bankruptcy amendment regarding repos would "have any effect on the characterization of repos under the tax laws", stated that enactment of the amendment "should not affect the characterization of repos under the tax laws because these bills do not characterize, for either tax or bankruptcy purposes, repurchase agreements as either secured

loans or as purchases and sales." *Bankruptcy Law and Repurchase Agreements: Hearing on H.R. 2852 and H.R. 3418 Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary,* 98th Cong., 2d Sess. 106. Expanding on the Federal Reserve's position, Mr. Sternlight further stated that, "while the Federal Reserve has gone on record as favoring purchase-and-sale characterization of repurchase agreements, **that statement is limited to a bankruptcy context and should not be taken as an endorsement of purchase-and-sale characterization for tax, accounting, or other purposes.** *Id.* at 106-107. (emphasis added).[21]

The record plainly does not support the Nebraska Supreme Court's conclusion that Nebraska's tax on income distributed to Loewenstein by the Trusts resulting from repos involving federal obligations impermissibly burdens federal obligations or interferes with the borrowing ability of the United States. The affidavit of Peter Sternlight, relied upon by the majority below, contains

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[21] The concerns expressed to Congress by the securities industry were also limited to the context of the treatment of repos under bankruptcy law. Thomas W. Strauss, Chairman of the Public Securities Association, "a national trade association representing 300 banks, brokers, and dealers who underwrite and sell U.S. Government and Federal agency securities," referred to Mr. Sternlight's testimony "describ[ing] the problem in the repo market brought about by the Lombard-Wall bankruptcy proceeding and related events." *Bankruptcy Reform Hearing, supra,* at 307. His testimony reflects that the industry's concern related to the treatment of repos in bankruptcy proceedings, and he acknowledged that "repos may be characterized as one of several types of transactions, for tax law, securities law, and many other purposes." *Id.* at 308.

nothing to support such a conclusion. The majority simply took his statements and used them wholly out of context. Mr. Sternlight expressed no view whatsoever as to the effect of state taxation of repo income. "[W]hen the effort is made . . . to establish the unconstitutional character of a particular tax by claiming that its remote effect will be to impair the borrowing power of the government, courts in overturning statutes, long established and within the ordinary sphere of state legislation, ought to have something more substantial to act upon than mere conjecture. The injury ought to be obvious and appreciable." *Plummer v. Coler,* 178 U.S. 115, 137-38 (1900). The decision of the court below violates this principle. It is based on nothing more than pure speculation and conjecture as to the alleged "impact" of state taxation of repo income on the federal government.

The Nebraska Supreme Court also failed to give proper consideration to the Court's decision in *Rockford Life Ins. Co. v. Dept. of Revenue,* 482 U.S. 182 (1987). In *Rockford Life,* the Court addressed whether "Ginnie Maes" were exempt from state taxation under the federal government's constitutional immunity from taxation or under the immunity statute. The Court held that "Ginnie Maes" were not entitled to exemption on either ground, finding that these instruments did not constitute obligations of the United States, and, therefore, were not immune from state taxation. In holding the instruments did not constitute obligations of the United States under the immunity statute, the Court noted that, while the instruments contained a pledge of the "full faith and credit of the United States", they were "neither direct nor certain obligations of the United States . . . ," as the issuer

bore "the primary obligation to make timely payments – the United States' obligation [was] secondary and contingent." *Id.* at 188.

As to the claim of constitutional immunity, the Court noted the instruments contained no "binding promise by the United States to pay specified sums at specified dates." *Id.* at 189-90 (*quoting Smith v. Davis,* 323 U.S. at 115)). As one of the principal purposes of the intergovernmental tax immunity doctrine is to prevent "States from taxing federal obligations in a manner which has an adverse effect on the United States' borrowing ability . . . ", the Court concluded that "[t]he lack of a fixed and certain obligation by the United States in the Ginnie Mae context ma[de] this concern far too attenuated to support constitutional immunity." *Id.* at 190 (citations and footnote omitted). Moreover, "none of the proceeds of the issuance and sale of the [Ginnie Mae] certificates [were] received by the Federal Government or used to finance any governmental function." *Id.* at 191.

The reasoning in *Rockford Life* applies in this case. There is no direct and certain obligation of the United States government to the Trusts under the repurchase agreements. The agreements, by their terms, specify that the Trusts will not receive the monies promised by the federal government in the securities which are the subject of the repurchase transaction (J.A. 69). In the event of default by the seller-borrower, the Trusts may sell the obligations at their then-current market value to yet another party and obtain cash from that party (J.A. 73). Thus, the federal government does not even stand as a guarantor in relation to the Trusts.

Moreover, as in *Rockford Life*, the federal government never receives the proceeds of the repurchase transactions. The proceeds flow between private parties, the underlying federal obligations already having been issued at the time the repurchase transaction takes place. This further undermines the majority's finding that exemption was required because "the state tax impose[d] a burden on the market for federal securities." (Pet. Cert. App. A-13). Given the nature of repurchase transactions, it is difficult to conceive how taxation of income derived from repos and distributed to shareholders of the Trusts imposes an impermissible burden on the borrowing power of the federal government. Absent "a significant effect on the marketability or interest costs of federal securities," . . . , attempts to "find grounds for derivative tax immunity in every speculative marginal advantage for those who deal with the government and therefore to the government pushes the search for an economic incidence (as distinct from the legal incidence) of a tax too far." *Borg v. Dept. of Revenue*, 308 Or. at 40, 774 P.2d at 1102 (*citing* Tribe, American Constitutional Law 514-18 (2d ed. 1988)).

CONCLUSION

Section 3124 does not require that Nebraska exclude from taxable income distributions from the Trusts received by Loewenstein resulting from repurchase agreements involving federal obligations. The income derived from these transactions and distributed by the Trusts to shareholders such as Loewenstein is simply interest paid to the Trusts as a result of private sector loan

agreements in which federal obligations served as collateral. Moreover, there is nothing in the record to support the state court's conclusion that Nebraska's taxation of this income would impermissibly burden federal securities, or impair the borrowing ability of the United States. The decision of the Supreme Court of Nebraska should be reversed.

Respecfully submitted,

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In The

Supreme Court of the United States

October Term, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE,

Petitioner,

v.

JOHN LOEWENSTEIN,

Respondent.

On Writ Of Certiorari
To The Supreme Court Of Nebraska

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SUMMARY OF ARGUMENT

Congress has determined that obligations of the federal government are exempt from taxation by the states. This Court has held the exemption is "sweeping" and extends to every form of state taxation which requires that such obligations or the interest thereon be considered in calculating the tax. *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 862 (1983). Respondent, through mutual funds, earned interest on federal obligations which are subject to repurchase agreements. The State of Nebraska impermissibly sought to tax this income and the Nebraska Supreme Court properly declared the Nebraska revenue rule at issue invalid.

The mutual funds in which respondent owns shares invest in federal obligations through the use of repurchase agreements to lock in a specified rate of return for a short term investment without running the risk that a change in interest rates will cause them to lose not only their interest earnings but part of their capital. In every other respect, the mutual funds' purchases of federal obligations are identical to purchases by investors who have not chosen to use repurchase agreements. The repurchase agreements are structured as purchases and sales for valid business reasons unrelated to tax issues. The structure of the transactions chosen by the parties should be respected.

If the Nebraska revenue ruling is not invalidated, petitioner will be permitted to tax part or even all of the interest income generated by federal obligations held by Nebraskans in violation of 31 U.S.C. § 3124 (1988) and the Supremacy Clause, U.S. Const. art. VI. Not only is there

no "double tax benefit" under this revenue ruling; if petitioner's position is upheld, no one will obtain the complete benefit of the exemption of interest on federal obligations from state taxation mandated by Congress. In addition, since the tax is imposed only on federal obligations that are subject to repurchase agreements but not upon similar state obligations, Nebraska impermissibly discriminates against the holders of federal obligations.

The determination of whether a state tax on federal obligations is invalid involves a two step process. First, the court must determine whether Congress has prohibited the states from imposing such a tax. Second, if the tax is not barred by statute, the court must determine "whether the constitutional doctrine of intergovernmental tax immunity requires any broader exemption." *Rockford Life Ins. Co. v. Illinois Dep't of Revenue*, 482 U.S. 182, 188 (1987). This brief will demonstrate that the Nebraska income tax which petitioner seeks to impose on respondent is invalid under both tests.

ARGUMENT

I. CONGRESS DID NOT INTEND TO PERMIT STATES TO TAX INCOME DERIVED FROM FEDERAL OBLIGATIONS SUBJECT TO REPURCHASE AGREEMENTS.

A. Repurchase Agreements are Merely a Way for Multiple Taxpayers to Share Income Exempt from State Taxation.

Perhaps the easiest way to understand repurchase agreements conceptually is to think of them as the

securities equivalent of real property time share agreements. A series of investors each own the same federal obligation for a limited number of days and divide among themselves the interest paid by the federal government.

Consider a situation in which thirteen investors are each willing to loan the federal government $10,000 for a different thirty consecutive day period. A dealer in federal obligations initially purchases a treasury bill for $9,740 at a treasury auction[1] and immediately sells it to Investor A for $9,740 with an agreement to repurchase it thirty days later for $9,769. After thirty days, the dealer

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[1] The authority to issue treasury bills is found at 31 U.S.C. § 3104 (1988). The hypothetical price of $9,740 was chosen to provide for $360 in interest, or $1 per day, to allow for simplicity in calculations. A leading authority explains treasury bills, or T bills, as follows:

> T bills bear no interest. An investor in bills earns a return because bills are issued at a discount from face value and redeemed by the Treasury at maturity for face value. The amount of the discount at which investors buy bills and the length of time bills have to be held before they mature together imply some specific yield that the bill will return if held to maturity. T bills are currently issued in 3-month, 6-month, and 1-year maturities. In issuing bills, the Treasury does not set the amount of the discount. Instead, the Federal Reserve auctions off each new bill issue to investors and dealers, with the bills going to those bidders offering the highest price, that is, the lowest interest cost to the Treasury. By auctioning new bill issues, the Treasury lets currently prevailing market conditions establish the yield at which each new issue is sold.

M. Stigum, *The Repo and Reverse Markets* (1989) 14.

repurchases the security as agreed[2] and then sells it to Investor B with an agreement to repurchase it thirty days later for the sale price plus $29, again earning $1.00. This process is continued throughout the year. By the end of the year, there would be thirteen investors who had each earned $29 in income exempt from state taxation and the dealer would have earned $13 in income exempt from state taxation.[3]

Thus, the parties have devised a way in which to collectively purchase a federal obligation which none of them individually would have been able to purchase and hold to maturity and they have allocated among themselves the total interest paid by the federal government which is exempt from state taxation. It is this interest income from federal obligations which petitioner improperly sought to tax.

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[2] During this thirty day period, the federal obligation would earn $1 a day or $30 in interest. However, the purchaser of the security pursuant to the repurchase agreement typically earns slightly less than the earnings on the underlying instrument. The additional dollar is the dealer's profit on the transaction.

[3] Note that the economic substance of these transactions is that the thirteen individuals have collectively provided $10,000 to the federal government to finance the national debt while the dealer provided services but *no* funds of its own. Yet petitioner argues that *none* of the exempt interest should be allocated to the thirteen individuals who provided *all* of the funds. Petitioner's Brief at 32. Clearly, such an approach would not reflect the economic substance of the transaction.

B. Congress Intended the Exemption of Federal Obligations From State Taxation to be Broad and Sweeping.

Prior to 1959 there existed a "formal but economically meaningless distinction between taxes on Government obligations and taxes on separate interests. . . ." *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 858 (1983). However, in 1959 Congress amended the applicable statute, "set aside this Court's rather formalistic pre-1959 approach," and adopted a "sweeping" exemption for federal obligations. 463 U.S. at 862. Congress decreed that "[t]he exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax." 31 U.S.C. § 3124(a) (1988). "Under the plain language of the 1959 amendment . . . the tax is barred regardless of its form if federal obligations must be considered, either directly or indirectly, in computing the tax." 463 U.S. at 862.

Under the statute, "considered" means "taken into account or included in the accounting." *Id.* The issue, therefore, is not the formal one of determining who "owns" the government obligations that are the subject of a repurchase agreement. Rather, the question is whether taxation of the mutual funds' income from purchasing and selling federal obligations subject to repurchase agreements is a form of taxation that requires that the obligations, the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax. Clearly, taxation of respondent's income earned by the mutual funds through buying and

selling federal obligations requires that the federal obligations be "considered, either directly or indirectly, in computing the tax." *Id.* The prohibition of taxing federal obligations is therefore violated.[4]

C. State Taxation of Income Earned Under Repurchase Agreements Which Requires That Federal Obligations be Considered Violates 31 U.S.C. § 3124 (1988).

The mutual funds in this case earn no income when they first enter into a repurchase agreement. Indeed, all that occurs is that the mutual funds transfer cash to the seller and the federal obligations are transferred to a custodian for the mutual funds (J.A. 62-63, ¶¶ 10-13). The mutual funds only recognize income at the conclusion of the transaction. This occurs in one of two ways. If the seller defaults and fails to repurchase the federal obligations, the mutual funds sell those obligations with the intention of recovering the original purchase price plus

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[4] The taxable character of respondent's income as a mutual fund shareholder is the same as its character in the hands of the mutual funds. By statute, respondent is entitled to subtract "that portion of the total dividends and other income received from a regulated investment company which is attributable to obligations described in subdivision (a) [obligations exempt from state income taxes] of this subsection as reported to the recipient by the regulated investment company." *Neb. Rev. Stat.* § 77-2716(1)(b) (1993). Thus, the Nebraska Supreme Court did not consider the question of whether such a "pass-through" of tax exempt status is required by either 31 U.S.C. § 3124 (1988) or the Supremacy Clause. Accordingly, contrary to the argument of the amici curiae State of California *et al.* at p. 17 of their brief, this issue is not before this Court. 28 U.S.C. § 1257(a) (1988).

the agreed upon interest. At this point the mutual funds would clearly have realized income requiring consideration of "either the obligations or the interest thereon, or both" which would be exempt from taxation by the State.

The other, and presumably more common alternative, is for the original seller to carry out its obligations and repurchase the government obligations at the agreed-upon price. (J.A. 63, ¶ 18). The mutual funds' profit on this resale reflects income earned by them in consideration of their holding of government obligations just as surely as the income they would receive in the first instance in the event of a default. *In either event the mutual funds recognize no income until they transfer the government obligations.* The economic reality is that whatever income the mutual funds derive from these transactions arises in consideration of the federal obligations that are the subject of the transaction. As a result that income must be exempt from taxation by the State of Nebraska.

D. Semantic Distinctions Without a Difference Should Not Change the Tax Result.

Petitioner argues that the federal obligations and the interest on them are not "considered" in repurchase transactions by advancing a number of semantic distinctions that make no difference.

1. Taxpayers earning exempt income need not receive a check directly from the federal government.

Petitioner argues that a party to a repurchase transaction does not receive a check from the federal

government labeled interest: therefore that investor cannot have exempt income. A federal obligation may change hands dozens of times between interest payments or before it matures. The interest earned by the obligation over its life, or between interest payment dates, is distributed ratably among the various parties based on the number of days they held the obligation.[5] If the rule were otherwise, parties could avoid paying any state income tax whatsoever by simply buying federal obligations the day before they matured or an interest payment was due and then claiming an exemption for all of the interest paid on that date, even though the party had only owned the obligation for one day. Thus, parties to repurchase transactions are no different than other investors who trade federal obligations and earn tax-exempt income, even though they never receive a check from the federal government.

2. An investor's rate of return is determined by the market, not by the nominal rate on the face of the obligation.

Next, petitioner argues that repurchase transactions are somehow different from other purchases of federal obligations because the rate of return which an investor earns differs from the nominal interest rate on the face of the obligation. But, again, the same is true of all investors in federal obligations.[6] The nominal rate of interest on a

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[5] I.R.C. §§ 1271 and 1276.

[6] The only exception would be an investor who buys an obligation at par and holds it to maturity.

treasury note or bond affects an investor's rate of return only indirectly.[7] For example, if current rates on new issue four year $1,000 notes are 8.5%, but an investor finds a six month old outstanding similar obligation bearing 8% nominal interest, the investor will be able to buy the 8% note for $985.13.[8] Both obligations, either the new issue purchased for $1,000 or the outstanding issue purchased for $985.13, would yield an investor 8.5% to maturity. The investor's rate of return is determined by current market interest rates, not by the nominal rate on

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[7] Notes are authorized by 31 U.S.C. § 3102 (1988); bonds by 31 U.S.C. § 3103 (1988). Like the yield on treasury bills, the yield on notes and bonds is also determined by auction.

> The Treasury also issues interest-bearing *notes*. These securities are issued at or very near face value and redeemed at face value. Notes have an *original maturity* (maturity at issue) of 2 to 10 years. Currently, the Treasury issues 2-, 3-, 4-, 5-, 7-, and 10-year notes on a regular cycle. Notes of other maturities are issued periodically depending on the Treasury's needs. Interest on Treasury notes is paid semiannually. Notes, like bills, are sold through auctions held by the Federal Reserve. In these auctions participants bid yields, and the securities offered are sold to those dealers and investors who bid the lowest yields, that is, the lowest interest cost to the Treasury. Thus, the coupon rate on new Treasury notes, like the yield on bills, is determined by the market. . . .
>
> In addition to notes, the Treasury issues interest-bearing negotiable *bonds* that have a maturity at issue of 10 years or more. The only difference between Treasury notes and bonds is that bonds are issued in longer maturities.

Stigum, *supra*, at 14.

[8] Stigum, *supra*, at 45-46.

the face of the federal obligation, and this is true whether or not a repurchase agreement is involved.

3. "Market Risk" is not required by the statute.

Finally, petitioner argues that the interest earned by holders of federal obligations subject to repurchase agreements should not be exempt from state taxation because they are not subject to any market risk. Petitioner offers no explanation why exposure to market risk should be the *quid pro quo* that a taxpayer must bear to have tax-exempt income. Congress certainly did not include the words "own" or "ownership" or any similar concept in 31 U.S.C. § 3124(a) (1988).[9]

The statute focuses on the obligation or interest earned by the obligation. In other words, the "price" paid by the federal government for the use of the investor's funds is exempt from taxation regardless of who receives it or how they receive it. The concept of "ownership" is simply not an issue under 31 U.S.C. § 3124.

Parties to all kinds of commercial transactions take steps to limit their exposure to market risk without changing their tax status. The owner of a stock can buy an option giving the owner the right to sell the stock at a

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[9] Title 31, U.S.C. § 3124(a) (1988), provides that:
Stocks and Obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax.

specific price even if the market price should drop. The owner of real estate who sells his property can continue to take interest and depreciation deductions right up to the day of closing even though he is no longer effectively subject to market risk once the purchase agreement is signed. There is simply no reason for this Court to imply a "market risk" requirement when Congress has not seen fit to explicitly impose one.

E. The Nebraska Supreme Court Correctly Held That Income Earned from Federal Obligations Subject to Repurchase Agreements is Exempt from State Taxation.

Congress adopted a broad and sweeping exemption for earnings from federal obligations in 1959. In doing so, it expressly rejected arbitrary semantic distinctions. This Court should reject the petitioner's suggestion that the exemption of income earned by federal obligations from state taxation should again be determined by applying meaningless labels or pigeonholing transactions. Interest earned by federal obligations which are the subject of repurchase transactions is interest the taxation of which requires that federal obligations be considered either directly or indirectly. Congress has explicitly, clearly, and definitively indicated that it intends such income to be exempt from taxation by the states. The Nebraska Supreme Court therefore correctly determined that Revenue Ruling 22-85-1 violated 31 U.S.C. § 3124 (1988) and this Court should affirm that decision.

II. THE ALLOCATION OF RIGHTS, DUTIES, AND ECONOMIC RESULTS BY THE PARTIES TO A TRANSACTION HAVING ECONOMIC SUBSTANCE INDEPENDENT OF TAX CONSIDERATIONS SHOULD BE HONORED BY TAX AUTHORITIES.

A. Parties are Free to Structure a Transaction to Meet Individual Needs Without Government Interference.

The parties to a repurchase agreement have explicitly agreed that one party will buy and another party will sell specifically identified securities at a mutually agreed upon price. Pursuant to the agreement, a notation is made on the book-entry system of the Federal Reserve transferring ownership of the specific securities involved from the seller to the buyer. Courts should not interfere with the structure of transactions chosen by taxpayers when "the Government is likely to lose little revenue, if any, as a result of the shape given the transaction by the parties," especially when "[n]o deduction was created that [was] not either matched by an item of income or that would not have been available to one of the parties if the transaction had been arranged differently." *Frank Lyon Co. v. United States*, 435 U.S. 561, 580 (1978). The petitioner's purpose in adopting the challenged revenue ruling was to try to reach income that would otherwise be tax exempt, thereby increasing its revenues at the expense of the federal government and taxpayers investing in federal obligations. The petitioner has not and cannot meet the standards announced by this Court that would allow petitioner to recharacterize this transaction to suit its own revenue enhancing purposes.

In *Frank Lyon Co.*, this Court upheld the taxpayer's characterization of a sale-leaseback transaction because the structure of the transaction was determined primarily by business and regulatory factors and not tax avoidance. The Court announced the following rule:

> [W]e hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties

435 U.S. at 583-84. Thus, even though "none of the parties to this sale-and-leaseback was the owner of the building in any simple sense," 435 U.S. at 581, the taxpayer was entitled to depreciation deductions as the "owner" of the building because that was how the transaction had been structured for business and economic reasons independent of tax considerations.[10] Courts have subsequently recognized that the "substance over form" argument

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[10] The Court recognized that a party may properly take tax considerations into account, as long as tax avoidance is not the sole motive of the structure of the transaction: "The fact that favorable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing those consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction." 435 U.S. at 580.

advanced by petitioner in this case has a very restricted role.[11]

> The substance over form or economic reality argument is not a broad legal doctrine designed to distinguish between legitimate and illegitimate transactions and employed at the discretion of the tax court whenever it feels that a taxpayer is taking advantage of the tax laws to produce a favorable result for the taxpayer. . . . In general, absent specific congressional intent to the contrary, . . . , a court cannot disregard a transaction in the name of economic reality and substance over form absent a finding of sham or lack of business purpose under the relevant tax statute.

Humana, Inc. v. Commission, 881 F.2d 247, 254-55 (6th Cir. 1989).

Courts have generally construed *Frank Lyon Co.* as mandating that a transaction be examined from two perspectives. "To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists." *Rice's Toyota World, Inc. v. Commission*, 752 F.2d 89, 91 (4th Cir. 1985). Another court has phrased the issue thusly:

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[11] This Court rejected the argument by the government for a "rule calling for a realistic approach to tax situations" because "so broad and unchallenged a principle furnishes only a general direction, [and] . . . is of little value in the solution of tax problems." *Higgins v. Smith*, 308 U.S. 473, 476 (1940).

> In determining whether a transaction is a sham, courts typically focus on two related factors: 1) has the taxpayer shown that it had a business purpose for engaging in the transaction other than tax avoidance? 2) Has the taxpayer shown that the transaction had economic substance beyond the creation of tax benefits?

Bail Bonds by Marvin Nelson, Inc. v. Commission, 820 F.2d 1543, 1549 (9th Cir. 1987).

Focusing on these two factors does not imply "a rigid two-step analysis. Instead, the consideration of business purpose and economic substance are simply more precise factors to consider in the application of this court's traditional sham analysis; that is, whether the transaction had any practical economic effects other than the creation of income tax losses." *Sochin v. Commission*, 843 F.2d 351, 354 (9th Cir. 1988). A precise formulation of the test is not determinative in this case. Regardless of how a repurchase transaction is viewed, the parties are motivated by business and regulatory concerns that are independent of tax considerations. Therefore, there is no authority for the petitioner's attempt to recharacterize repurchase agreements as something other than the transaction which the parties themselves formulated.

B. Repurchase Agreements are Structured By Investors as Sales for Valid Business Reasons.

The use of repurchase agreements evolved for reasons totally unrelated to tax considerations.[12] Federal securities offer investors numerous advantages. First, there is almost no default risk. Second, they are traded in large numbers and thus highly liquid. Third, they are widely available in a variety of denominations and maturity dates. Thus federal securities are an ideal choice for long-term investors who are seeking a safe investment offering a reasonable rate of return.[13]

However, federal securities have one chief disadvantage as short-term, i.e., several day, investments. Investors who have funds they know they will need within a few days run a risk that they will actually lose money if they buy federal securities. Unlike an investor putting money in a checking or savings account or certificate of deposit, a purchaser of federal securities is not certain to obtain all of the investor's money back if the security must be sold prior to maturity.

The following illustration demonstrates this point. Assume that a corporate or municipal treasurer has $9.5 million in cash on Tuesday that will be needed to pay bills due on Friday. If the current rate of interest on twelve month treasury bills was approximately 5.25%, the

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[12] Indeed, a significant number of participants in the repurchase market are entities such as cities and states which pay no income tax. Stigum, *supra*, at 113.

[13] Stigum, *supra*, at 15.

treasurer could buy securities worth $10 million at maturity for $9.5 million when they were issued on Tuesday[14] and resell them on Friday for $9,504,166, earning the company or municipality $4,166 in the process.[15] However, if in the intervening three days the Federal Reserve raises interest rates on comparable securities to 5.5%, then on Friday when the securities were sold, they would be worth only $9,483,017, resulting in a net loss of $16,983.[16]

Although a sophisticated securities trader might be willing to risk such a loss for the specified return, the treasurer of a conservative corporation or municipality would not.[17] Repurchase agreements evolved, from an investor's point of view, for the purpose of avoiding this interest rate risk.[18] If an investor could simultaneously

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[14] $9,500,000 x 5.26315% (actual interest rate) = $500,000 interest + purchase price = $10,000,000 value at maturity.

[15] $9,500,000 x 5.26315% ÷ 360 days in a year x 3 days = $4,166.66.

[16] $10,000,000 value at maturity ÷ 1.055 (1 plus rate of interest) = $9,478,672.90 + 3 days interest at 5.5% ($4,344.39) = $9,483,017.20.

[17] A sophisticated investor could also guard against market risk by purchasing a security and then separately purchasing a put (a right to sell the security at a specified time at a specified price) without foregoing the right to tax exempt interest. Rev. Rul. 82-144, 1982-2 C.B. 34. That is essentially what a repurchase agreement is.

[18] This problem of interest rate risk is unique to short-term investors. The long-term investor can simply hold the security to maturity and then receive back the face amount of the instrument without incurring any capital loss. But for any party needing its money before the instrument matures, there is always a risk of getting back less than was initially invested.

agree to purchase the securities for $9.5 million on Tuesday and to resell them on Friday for an additional $4,156, the investor would have locked in a reasonable rate of return and avoided the possibility of an actual capital loss. Repurchase agreements are designed to achieve exactly this result.

Petitioner contends that the price a prudent investor in federal obligations must pay for this protection against interest rate risk is the loss of the exemption from state taxation of the interest income earned on this investment. But the petitioner offers no principled reason why an investor who wants to invest in federal obligations on a short-term basis must accept the interest rate risk as the *quid pro quo* for maintaining the tax-exempt status of the income earned. Investors who have purchased federal obligations that are the subject of repurchase agreements have provided funds to the federal government for the purpose of financing the national debt just like any other investors. They earn interest on their investment and that interest should be exempt from taxation by the states just as is the interest earned by investors who do not engage in repurchase transactions. There is no rational reason to treat them any differently.

C. The United States Government Also Benefits From Repurchase Agreements.

There is a third party which benefits from repurchase transactions as well. To be able to continue to finance government operations and refinance existing debt, it is

critical to the federal government that it have ready access to the credit markets. To facilitate liquidity, federal obligations are freely transferable and their ownership is tracked in the Federal Reserve's book-entry system. Although it is true that once obligations are issued, it is of no particular concern to the United States Government who holds them, it is nonetheless true that an active secondary market in United States obligations is critical to their liquidity and marketability which directly affect the rate of interest that the federal government must pay to finance the national debt. Obviously, an investor who purchased a thirty-year treasury bond with the knowledge that there was no way to obtain access to the investor's funds throughout the next thirty years would extract a substantially higher return than one purchasing thirty-year bonds with the knowledge that they could readily be traded the next day or anytime during the succeeding thirty-year period should the need arise. Thus, the liquidity provided by the repurchase market in federal obligations serves the interests of both private and public investors as well as the federal government.

D. This Court Should Not Sanction a Unique Characterization of Repurchase Agreements Solely for Tax Purposes.

Petitioner recognizes, as it must, that in myriad other circumstances, courts have recognized that there is no reason to treat the sale of a security pursuant to a repurchase agreement differently than any other sale of a

security.[19] In addition to the bankruptcy and securities law circumstances mentioned by petitioner, repurchase transactions are treated as ordinary sales and purchases of securities in other contexts as well. For example, in determining whether a tax-exempt fund has met the SEC's diversification requirements, a "repurchase agreement shall be deemed to be an acquisition of the underlying securities, provided that the obligation of the seller to repurchase the securities from the money market fund is Collateralized Fully." 17 C.F.R. § 270.2a-7(c)(4)(i)(B)(2) (1993). Similarly, the Comptroller of the Currency has ruled that federal bank lending limits do not apply to repurchase transactions involving federal securities. 12 C.F.R. § 32.103 (1994). These regulations simply recognize that an investor who acquires an obligation pursuant to a repurchase agreement has legal title to that obligation and effectively owns the security until the investor carries out the second half of the transaction and reconveys it to the original seller.

Even the petitioner's counsel and other attorneys general have recognized in other contexts that a repurchase agreement is nothing more than a purchase and subsequent sale of securities. State attorneys general have been asked frequently to determine whether state officials require specific authority to engage in repurchase transactions and whether those transactions

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[19] Petitioner's Brief at 22-23, n.10.

violate any state constitutional provisions against lending the credit of the state to a private individual.

Almost thirty years ago, the Attorney General of the State of California was asked to determine whether the State Treasurer was authorized to enter into repurchase agreements. At that time he concluded that "a repurchase agreement in final analysis is nothing more than a purchase and a sale of securities [and] any state investing agency which has authority to purchase and sell securities is endowed with authority to enter into a repurchase agreement." 44 Op. Cal. Att'y Gen. 140, 143 (1964). In so concluding, the Attorney General of California effectively refutes petitioner's principal arguments in this proceeding.

> We cannot see that the entering into an agreement to sell at the same time the state purchases in any way dilutes the state's interest in the property during the period between the original purchase and resale. For all intents and purposes, the state is the owner during this period and if for some reason the repurchase falls through, the state would remain the owner. No proceedings to foreclose or wipe out the title of the seller would be necessary. Likewise, it would seem that the state, after acquiring the securities, though it might subject itself to liability, could pass title to a third party if it chose to ignore its agreement to retransfer to the original seller. However, the risk of loss during the period between the original sale and the repurchase would be upon the state. If a tangible non-negotiable chattel were involved, the power to pass title and the shifting of risk of

loss to the purchaser would indicate the transaction was a sale rather than a bailment. There is no reason why the peculiar nature of the property involved, a negotiable instrument representing an obligation of the United States, should require the transaction to be looked upon as a pledge or something other than a sale.

It is true that from the seller's standpoint the transaction may serve as a substitute for a short-term loan in which the securities would be used as collateral. This, however, is not properly a consideration in determining the legality of the state's participation in the transaction. If there is an actual sale it is immaterial that the seller had a choice as to the manner in which he would attain his object. That he might have accomplished the same thing, that is, obtained the use of money for a certain period by means of a loan, does not make the alternative method by which it is accomplished a loan, and, hence an unauthorized act on the part of the Treasurer. It is accordingly concluded that the Treasurer is authorized to enter into repurchase agreements of the type set forth above.

Id. at 142-43.

Twenty-nine years later, the Attorney General for the State of Nevada reached the same conclusion: "Repurchase agreements are buy-sell transactions that do not violate the constitutional prohibition against the loan of state money." Nev. Att'y Gen. Op. No. 89-3, 1989 Nev. AG LEXIS 3. The Nevada Attorney General based his conclusion, in part, on the following:

> A majority of states provide statutory authorization for the investment of state moneys in repurchase agreements although most of those states, like Nevada, have constitutional prohibitions against the loan of state money or credit. The inference, of course, is that investments and repurchase agreements are not loans which would violate those constitutional prohibitions.

Id. at 5. The Attorney General for the State of West Virginia reached the same conclusion. "[W]e conclude that these agreements are contracts for the resale and repurchase of securities." 1990 W. Va. AG LEXIS 12, at 8.

A very thorough and thoughtful analysis of the issue is contained in Opinion No. 90-34 of the Attorney General of the State of Oklahoma. 1990 Okla. AG LEXIS 26. The Oklahoma Attorney General, after an exhaustive review of the authorities, concluded that "the relevant case law reveals that there is no comprehensive analytical approach which enjoys widespread acceptance and adherence by the courts." *Id.* at 21-22. He then went on to revoke two earlier attorney general opinions that held the use of repurchase agreements violated the Oklahoma Constitution and concluded "that participation in repurchase agreements, like investment in revenue bonds, obligations of the United States and high quality corporate obligations, does not offend the lending of the credit clause of the Oklahoma Constitution." *Id.* at 24.

The Nebraska Attorney General has reached a similar conclusion. Legislative Bill 379, adopted in 1989, and codified at *Neb. Rev. Stat.* § 79-1308.01(2) (1992), specifically authorized school districts to use repurchase agreements to invest their surplus funds. The Nebraska Attorney General was asked to opine whether such repurchase agreements violated Nebraska Constitution

art. XIII, § 3, which provides that the "credit of the state shall never be given or loaned in aid of any individual, association or corporation." The Attorney General of Nebraska concluded that repurchase agreements did not violate this provision.

> [R]epos authorized by LB 379 may be defined as written agreements whereby one party sells "securities" to another party with the understanding that at a future time certain the selling party will repurchase the securities at a stated higher price. It also appears that the only apparent legislative purpose in authorizing school districts to purchase repos is to maximize their return on funds which are not currently required for operational expenses of the school district.
>
> . . . We are therefore of the opinion that the authority granted by LB 379 to school districts to purchase repos does not violate Neb. Const. Art. XIII, § 3, for the reason that the apparent purpose is entirely public: to maximize the return on investment of school funds.

Neb. Att'y Gen. Op. No. 89023, at 2.

Respondent does not suggest that these attorney general opinions are binding upon this Court or even on the various states involved. However, these attorney general opinions do make it clear that even the attorneys general of petitioner and other states, when called upon to look at repurchase agreements outside the taxation arena, have recognized that repurchase agreements are exactly what they purport to be: the purchase of a security combined with a contemporaneous agreement to later resell it at an agreed upon price to the original seller. There is no

reason that this Court should adopt a different approach to these agreements that would be used *solely* in the taxation arena.

III. TREATING REPURCHASE AGREEMENTS AS PURCHASES AND SALES OF SECURITIES WILL NOT RESULT IN ANY "DOUBLE TAX BENEFIT" FOR INTEREST ON FEDERAL OBLIGATIONS.

A. The Challenged Revenue Rule Results in State Taxation of Income From Federal Obligations.

Repurchase agreements do not deprive the states of any revenue to which they would otherwise be entitled. Three hypothetical scenarios involving federal obligations will make this point clear.

1. Taxable federal income.

Since the starting point for the Nebraska income tax is a taxpayer's federal adjusted gross income,[20] any discussion of a Nebraska income tax on income from federal obligations must begin with a review of the applicable federal tax laws. For the purposes of this discussion, we will use the following hypothetical. On January 3, 1994 Taxpayer 1 purchases a 360-day, $10,000 treasury bill at original issue for $9,500.[21] This treasury bill matures on December 29, 1994 at which time the United States Treasury will pay the holder of the obligation $10,000. At that

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[20] *Neb. Rev. Stat.* § 77-2714.01(1) (1990).

[21] *See supra*, note 1, for an explanation of the process of auctioning treasury bills.

point, the actual cost to the United States Treasury for the use of the $9,500 for the year 1994 is $500.[22] If Taxpayer 1 holds this treasury bill to maturity, Taxpayer 1 will have $500 in taxable interest income at the federal level.[23]

2. Nebraska Adjustments to Federal Income.

If Taxpayer 1 were a Nebraska taxpayer, Taxpayer 1 would begin calculating his Nebraska income tax by using his federal adjusted gross income which would include the $500 in interest income on the United States treasury bill. However, he would then be entitled, at the state level, to further adjust his federal adjusted gross income by reducing it by $500, the amount received from the United States Government.[24] It is thus clear that

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[22] Redemption price at maturity ($10,000) minus issue price ($9,500) equals U.S. Treasury interest cost ($500).

[23] "In general, interest on United States obligations issued on or after March 1, 1941, and obligations issued by any agency or instrumentality of the United States after that date, is fully taxable;. . . . " Treas. Reg. § 1.61-7(b)(3). "When notes, bonds, or other certificates of indebtedness are issued by a corporation or the Government at a discount and are later redeemed by the debtor at the face amount, the original discount is interest, except as otherwise provided by law." Treas. Reg. § 1.61-7(c).

[24] There shall be subtracted [from federal adjusted gross income] interest or dividends received by the owner of obligations of the United States and its territories and possessions or of any authority, commission or instrumentality of the United States to the extent includable in gross income for federal income tax purposes but exempt from state income taxes under the laws of the United States.

Neb. Rev. Stat. § 77-2716(1)(a) (1990).

Taxpayer 1 would pay no Nebraska income tax on the $500 received as income on the treasury bill. 31 U.S.C. § 3124 (1988).

3. Analysis Involving Two Taxpayers.

The result is the same ($500 in total taxable income at the federal level, $0 in taxable income at the state level) when two Nebraska taxpayers are involved in the transaction instead of one. Assume that after holding the treasury bill for 180 days, Taxpayer 1 transfers it to Taxpayer 2, another Nebraskan, for its fair market value on that day of $9,750.[25] At maturity, Taxpayer 2 redeems the treasury bill for $10,000. Taxpayer 1 would have $250 in federal taxable income and Taxpayer 2 would also have $250 in federal taxable income.[26] Each of these Nebraska taxpayers would be entitled to reduce their federal adjusted gross income by $250, the amount of federal interest income they received, resulting in net taxable Nebraska income of $0. Note that Taxpayer 1 has $250 in tax-exempt income without ever receiving a check from the United States Treasury. The Internal Revenue Code and the regulations adopted under it require that Taxpayer 1 report that income as federal interest income and that characterization flows through to the taxpayer's Nebraska Income Tax Return because of Nebraska's wholesale adoption of federal tax law. *See Neb. Rev. Stat.* § 77-2714 (1990).

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[25] This assumes that interest rates have remained constant throughout the year. If rates changed, the exact dollar amounts allocated to Taxpayers 1 and 2 would be different, but total interest would remain $500.

[26] *See* I.R.C. § 1276; Treas. Reg. § 1.61-7.

These two hypotheticals demonstrate the following principles. First, the total amount of interest to be paid by the federal government is determined at the time that a treasury bill is issued although the interest is actually paid at the bill's maturity. Second, the total amount of interest paid by the federal government may be distributed among one or more taxpayers even though only one taxpayer receives a check from the federal government. Third, the sum of all federally taxable interest received by taxpayers must equal the amount of interest paid by the federal government. Fourth, the total amount of income exempt from state taxation must equal the amount of interest paid by the federal government.

4. Analysis Involving Repurchase Agreements.

It is this fourth and final principle which the petitioner seeks to avoid in violation of 31 U.S.C. § 3124 (1988). The fact that various taxpayers have entered into repurchase agreements throughout the year involving a federal obligation should not change the analysis or the net result for purposes of state taxation. Assume, for purposes of a third hypothetical, that after 180 days Taxpayer 1 again sells the treasury bill to Taxpayer 2 for $9,750. However, this time the agreement provides that Taxpayer 1 has the right and the obligation to repurchase the treasury bill on December 29, 1994 for the original purchase price of $9,750 plus $250 "interest." Assume further that on December 29, 1994 Taxpayer 1 repurchases the treasury bill as agreed for $10,000 and then redeems it for $10,000. Taxpayer 1 clearly has federal adjusted gross

income of $250.[27] Taxpayer 1 is then entitled under Nebraska law to exclude this $250 from his Nebraska adjusted gross income, making it $0, because it was derived from a federal obligation.[28]

Taxpayer 2 also has $250 in federal adjusted gross income as a result of the transaction. It is this portion of

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[27] The result is the same whether calculated in terms of gain on the sale of the security earned at the time the repurchase agreement is entered into ($9,750.00 - $9,500.00 = $250.00) or whether looked at in terms of net interest earned when the security is redeemed at maturity ($10,000.00 redemption price less $9,500.00 purchase price less $250.00 deductible interest cost equals net interest income, $250.00).

[28] Petitioner incorrectly suggests that such a taxpayer would be entitled to reduce his federal adjusted gross income by $500. Petitioner's Brief at 19-20, n.8. If this were the case, the taxpayer, who earned only $250 on the transaction, could exclude the $250 earned from his Nebraska taxable income and also "shelter" another $250 from some other source, a true case of abuse of tax-exempt obligations. To prevent such a result, Nebraska law requires that the taxpayer net his interest costs against the income received from the federal obligation.

> Any amount subtracted under this subsection [the federal interest exclusion] shall be reduced by any interest on indebtedness incurred to carry the obligations or securities described in this subsection or the investment in the regulated investment company and by any expenses incurred in the production of interest or dividend income described in this subsection to the extent that such expenses, including amortizable bond premiums, are deductible in determining federal taxable income.

Neb. Rev. Stat. § 77-2716(1)(e)(i) (1993). Thus there is no risk of a "double tax benefit." *See also* discussion of the analogous federal provision, I.R.C. § 265, in the next subsection of this brief.

the tax-exempt interest paid by the federal government that petitioner seeks to tax in violation of 31 U.S.C. § 3124 (1988). Under the fourth principle announced above (total income exempt at the state level must equal total interest paid by the federal government), the $250 earned by Taxpayer 2 must also be exempt from state taxation. Otherwise, even though the federal government had paid $500 in interest exempt from state taxation, only $250 would go untaxed by the State and a portion of the federal exemption would have simply disappeared.

As this series of hypotheticals demonstrates, this case has nothing to do with a "double tax benefit."[29] Nor are the taxpayers trying to transform otherwise taxable income into exempt income to the detriment of the State. Rather, it is clear that petitioner is seeking to erode or, at the limit, wipe out the exemption for income derived from federal obligations established by 31 U.S.C. § 3124 (1988).[30] Petitioner has advanced not a single public

[29] See Petitioner's brief at 19-20, n.8.

[30] In the case of a reverse to maturity (*see* Stigum at 128-30 for an explanation of reverses to maturity and their uses), petitioner would tax **all** of the interest earned by a federal obligation. For example, if Taxpayer 1 purchased a federal obligation at issue for $9,500 and immediately sold it to Taxpayer 2 with the right and obligation to repurchase it 360 days later at maturity for $10,000, Taxpayer 2 would have $500 in Nebraska taxable income under petitioner's view of the law, thus obtaining no tax benefit, while Taxpayer 1 would obtain no tax benefit either since under *Neb. Rev. Stat.* § 77-2716(1)(e)(i) (1993) the interest received from the federal government and the interest paid to hold the obligation would cancel each other out. The net effect in such a situation is that the entire $500 paid by the federal government would be taxed by petitioner.

policy or tax equity reason why income which is clearly not subject to its taxing authority should become taxable in whole or in part because of repurchase transactions entered into by the parties at arm's length for reasons completely unrelated to taxation.

If parties have decided to divide federal interest as would be required by I.R.C. § 1276 and Treasury Regulation § 1.61-7 on the sale of a bond between interest dates, and if the total amount of federal interest reportable remains unchanged, why should the Court seek to revise the transaction from the form it has been cast in by the parties and which all of the financial community understands? Income earned by taxpayers who invest in federal obligations that are the subject of repurchase transactions retains its exempt status and this Court should therefore sustain the Nebraska Supreme Court's decision below invalidating the petitioner's attempt to tax this income.

B. The 1986 Tax Reform Act Eliminated the Rationale for Union Planters.

The holding of the *Union Planters* line of cases does not support the petitioner's contention that "ownership" of federal obligations should be a determining factor for tax purposes.[31] The rule announced in these cases was adopted to fill a statutory lacuna that was subsequently addressed by Congress in the Tax Reform Act of 1986.

[31] *American Nat'l Bank v. United States*, 421 F.2d 442 (5th Cir. 1970); *Union Planters Nat'l Bank v. United States*, 426 F.2d 115 (6th Cir. 1970); *First American Nat'l Bank v. United States*, 467 F.2d 1098 (6th Cir. 1972).

Thus, the rationale of those cases is no longer valid under today's tax laws. It is not merely a coincidence that the taxpayers in all three cases were banks. Those cases were driven by the unique nature of the taxpayers, all of which were banks, not by the nature of repurchase transactions in general. *See Citizens Nat'l Bank v. United States*, 551 F.2d 832, 841 (Ct. Cl. 1977) (refusing to apply rule in an outsider dealer/bank context).

To understand the courts' concern in the *Union Planters* cases, we must begin with I.R.C. § 265. If a taxpayer borrowed money to purchase tax exempt securities and was allowed both to exclude the income on the securities and deduct the interest the taxpayer paid on its borrowing, this "double benefit" would lead to abuse of tax-exempt securities. Accordingly, Congress adopted what is now section 265 which disallows a deduction for interest incurred to finance purchases of tax-exempt securities.[32] In *Denman v. Slayton*, 282 U.S. 514 (1931), this Court upheld the predecessor to section 265 and explained its purpose as follows:

> The manifest purpose of the exception . . . was to prevent the escape from taxation of income properly subject thereto by the purchase of exempt securities with borrowed money.
>
> Under the theory of the respondent, "A," with an income of $10,000 arising from non-exempt securities by the simple expedient of

[32] "No deduction shall be allowed for . . . (2) [i]nterest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle." I.R.C. § 265(a)(2).

> purchasing exempt ones with borrowed funds and paying $10,000 interest thereon, would escape all taxation upon receipts from both sources. It was proper to make provision to prevent such a possibility. The classification complained of is not arbitrary, makes no improper discrimination, does not result in defeating any guaranteed exemption, and was within the power of Congress.

282 U.S. at 519-20.

The courts in the *Union Planters* cases were concerned about transparent attempts to evade this restriction by bond dealers whose portfolios of municipal bonds the banks were financing. Banks, unlike all other taxpayers, had historically been exempted from the operation of section 265 even though they obviously borrowed funds from their depositors, invested the money in tax-exempt obligations, and took deductions for the interest they paid to their depositors while excluding the interest they received from their taxable income.[33] Thus, the courts in the *Union Planters* cases were presented with atypical situations. The Code, in these particular cases, ceased to function in its normal symmetrical fashion where tax-exempt income resulted in a corresponding denial of a

[33] *See* Rev. Rul. 61-222, 1961-2 C.B. 58.

deduction for interest paid.[34] Therefore, the courts proceeded to restore symmetry to the transactions in the only way available to them. They determined that the tax exempt income would be allocated to the bond dealers who would then be denied an interest deduction under section 265. The income received by the banks would be taxable, although the banks would enjoy an offsetting deduction for the interest they paid their depositors.

Today, however, there is no longer any need to recharacterize the parties' transaction in order to achieve symmetrical treatment under the Code. As part of the Tax Reform Act of 1986, Congress amended section 265 to make it specifically applicable to banks. Pub. L. No. 99-514 § 902 (1986). Moreover, it streamlined the operation of section 265 by doing away with a factual determination in each case of why funds were borrowed and whether they were used to finance the purchase of tax exempt securities or for some other purpose. Instead, Congress adopted a simple pro rata approach for financial institutions that abandoned any attempt to trace or allocate funds.[35] A bank's interest deduction is simply reduced by the portion of its income that is tax-exempt. The concern expressed by the court in *Union Planters* has

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[34] Note also that although *Union Planters* predated this Court's decision in *Frank Lyon Co.*, the requirements of that decision were nonetheless met. There was no valid business or regulatory reason advanced for structuring the transaction in the manner the parties had chosen. Clearly the sole purpose was to evade the strictures of section 265.

[35] "In the case of a financial institution, no deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable to tax-exempt interest." I.R.C. § 265(b)(1).

thus been obviated and the symmetrical treatment of exempt income and deductible interest has been restored.

Thus, while the *Union Planters* cases may have been correctly decided under the law at the time, their rationale is no longer viable under present law. Now that banks are subject to the limitations of section 265, there is no danger of a double benefit in repurchase transactions.[36] Therefore the holding of the *Union Planters* cases should not be applied to the repurchase transactions presently before the Court.

IV. THE NEBRASKA TAX ON REPURCHASE AGREEMENT INCOME IS AN UNCONSTITUTIONAL DISCRIMINATORY BURDEN ON FEDERAL BORROWING POWER.

A. States May Not Adopt a Tax Which Discriminates Against Federal Obligations.

Even if this Court were to determine that a state is permitted to tax income derived from federal obligations which are the subject of repurchase agreements, the Nebraska approach to the taxation of such income would violate the constitutional prohibition against discriminatory taxation of federal obligations.[37] In *Memphis Bank &*

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[36] Congress did include a "small issuer" exception that would still allow financial institutions to deduct interest payments on funds used to purchase tax exempt obligations in limited circumstances. I.R.C. § 265(b)(3). However, this Court should not adopt a rule applicable to all repurchase agreements based on this limited exception to the general rule.

[37] Revenue Ruling 22-85-1 dealt specifically and only with federal obligations. There is no comparable Nebraska revenue

Trust Co. v. Garner, 459 U.S. 392 (1983), this Court struck down a similarly discriminatory Tennessee bank tax which included interest from federal obligations, but not interest from Tennessee's own state obligations. This Court held that a "state tax that imposes a greater burden on holders of federal property than on holders of similar state property impermissibly discriminates against federal obligations." 459 U.S. 397. The Court then went on to hold that the Tennessee tax scheme was unconstitutional.

> It is clear that under the principles established in our previous cases, the Tennessee bank tax cannot be characterized as nondiscriminatory under § 742 [now 31 U.S.C. § 3124]. Tennessee discriminates in favor of securities issued by Tennessee and its political subdivisions and against federal obligations. The State does so by including in the tax base income from federal obligations while excluding income from otherwise comparable state and local obligations. We conclude, therefore, that the Tennessee bank tax impermissibly discriminates against the Federal Government and those with whom it deals.

459 U.S. at 398-99.

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ruling that makes interest income on state obligations which are the subject of repurchase agreements taxable at the state level. Nor do Nebraska statutes require that income earned on Nebraska obligations, which would be excluded from federal adjusted gross income, be added in to determine Nebraska taxable income. *Neb. Rev. Stat.* § 77-2716(1)(b) (1993). Nebraska tax law, therefore, clearly discriminates against income earned from federal obligations which are the subject of repurchase agreements.

This Court applied the same principle in *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803 (1989), concluding that it was unconstitutional for the State of Michigan to exempt from taxation retirement benefits paid by the state to its employees, but to tax the retirement benefits paid by all other employers including the federal government. The Court found there were no "significant differences" between the two classes of retirees and therefore the Michigan exemption of the retirement benefits which it paid was unconstitutional. 489 U.S. at 816-17. In so doing, the Court stated that "[t]his result is consistent with the underlying rationale for the doctrine of intergovernmental tax immunity. The danger that a State is engaging in impermissible discrimination against the Federal Government is greatest when the State acts to benefit itself and those in privity with it." 489 U.S. at 816, n.4. *Accord Barker v. Kansas*, 112 S. Ct. 1619 (1992) (state of Kansas could not constitutionally tax U.S. military retirement benefits while not taxing state and local government retirement benefits). These comments are particularly applicable to the present case. Nebraska Revenue Ruling 22-85-1 results in taxation of the earnings from federal obligations which are subject to repurchase agreements while neither this revenue ruling nor any other imposes such a burden upon state obligations which are subject to repurchase agreements. Just as the Tennessee, Michigan and Kansas taxes were unconstitutional, this Nebraska Revenue Ruling is also unconstitutional.

B. Taxation of Income From Repurchase Agreements Would Adversely Affect the Borrowing Ability of the United States.

The intergovernmental tax immunity doctrine "is based on the proposition that the borrowing power is an essential aspect of the Federal Government's authority and, just as the Supremacy Clause bars the States from directly taxing federal property, it also bars the States from taxing federal obligations in a manner which has an adverse effect on the United States' borrowing ability." *Rockford Life Ins. Co. v. Illinois Dep't of Revenue*, 482 U.S. 182, 190 (1987). The constitutional test in this case is whether imposition of the Nebraska income tax will place a burden, however slight, upon federal obligations which is not borne by obligations issued by the State of Nebraska.

Undisputed expert testimony makes it clear that a Nebraska income tax on federal obligations which are subject to repurchase agreements will make it more difficult and expensive for the federal government to finance the national debt and such a tax is therefore invalid. Peter D. Sternlight, Executive Vice President of the Federal Reserve Bank of New York (J.A. 25-26), testified that repurchase agreements play a substantial and important role in the market for United States Government securities, and therefore are also extremely important in the process of financing the national debt. (J.A. 28-29).[38]

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[38] As this Court noted in construing a predecessor to 31 U.S.C. § 3124 (1988), the purpose of the exception is to protect from state taxation "the interest-bearing obligations of the United States which are needed to secure credit to carry on the necessary functions of government." *Smith v. Davis*, 323 U.S. 111, 119 (1944).

Upon issuance of new government securities, the Federal Reserve distributes the securities to a limited number of "primary dealers" who then act as market-makers for the securities (J.A. 41-42, ¶ 6). The primary dealers, selected and approved by the Federal Reserve, then sell the federal securities to "secondary dealers," such as savings and loan associations, money market and mutual funds, insurance, financial, and other corporate investors. Secondary dealers, in turn, provide access to investment in the government securities to the public through a variety of mechanisms. In the context of this case, the mutual funds are secondary dealers.

Given the current large national debt, vast amounts of United States Government securities are issued from time to time. Repurchase agreements provide a financing function allowing dissemination of this huge quantity of debt to the investing public. Federal Reserve operations in the market on a single day through repurchase agreements frequently amount to more than $3 to $4 billion, and have reached as high as $7.9 billion (J.A. 40-41, ¶ 3).

Sternlight concluded: "The liquidity and flexibility provided by repurchase agreements are essential to the efficient functioning of the government securities markets." (J.A. 40, ¶ 3). The underwriting function for United States Treasury issues performed by "primary dealers" would be impaired by the inability to characterize repurchase transactions as sales transactions. Impairment of the repurchase market "would make it less attractive

for dealers to perform this very useful underwriting function, *thus adding to Treasury interest costs.*" (J.A. 41-42, ¶ 6, emphasis added).

The undisputed expert testimony before the courts below clearly establishes that state taxation of repurchase transactions would "add . . . to Treasury interest costs." This Court has consistently held that such a discriminatory burden on federal obligations is impermissible. *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983). Therefore, the Nebraska Supreme Court correctly concluded, based upon the factual record before it, that the revenue ruling at issue contravened the U.S. Constitution and 31 U.S.C. § 3124 (1988).

CONCLUSION

For almost 150 years this Court labored to define the limits of intergovernmental tax immunity. It typically resolved individual cases by employing an arbitrary semantic test which this Court itself recognized was based on the "formal but economically meaningless distinction between taxes on Government obligations and taxes on separate interests [which] was 'firmly embedded in the law.' " *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 858. Then, in 1959, Congress amended the applicable statute, ultimately codified as 31 U.S.C. § 3124, and adopted a "sweeping" exemption for income derived from federal obligations in any way. 463 U.S. at 862. It is this exempt income which petitioner seeks to tax in this case.

Petitioner urges that this result be reached by returning to the discredited semantic approach employed before 1959. And it suggests that the semantic test to be employed is whether the taxpayer was the "owner" of federal obligations, a word conspicuously absent from the text of the controlling statute. In the ultimate irony, it urges that this result is compelled by the "economic reality" of the transaction at issue when it is clear that the real effect of the rule argued for by the petitioner would be to impose a state tax on interest income from federal obligations just as surely as if the Legislature of the State of Nebraska had explicitly announced its intention to ignore the dictates of 31 U.S.C. § 3124 and the Supremacy Clause and tax the income of its citizens earned through investing in federal obligations. The Nebraska Supreme Court correctly determined that the actions of the petitioner violated 31 U.S.C. § 3124 and this Court should sustain that decision.

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STATE OF NEBRASKA, DEPARTMENT OF REVENUE,

Petitioner,

v.

JOHN LOEWENSTEIN,

Respondent.

On Writ of Certiorari
To The Supreme Court of Nebraska

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No. 93-823

In Th:

Supreme Court of the United States

October Term, 1994

STATE OF NEBRASKA, DEPARTMENT OF REVENUE,

Petitioner,

v.

JOHN LOEWENSTEIN,

Respondent.

On Writ of Certiorari
To The Supreme Court of Nebraska

REPLY BRIEF OF PETITIONER

Respondent presents five arguments in support of his position that income he received from mutual funds derived from repos involving federal obligations is exempt from Nebraska taxation under § 3124. First, Respondent argues that repos are "merely a way for multiple taxpayers to share income exempt from state taxation" and that repos are simply a device allowing the parties to "collectively purchase a federal obligation" in which they "have allocated among themselves the total interest paid by the federal government which is exempt from taxation." Brief of Respondent at 2, 4. Respondent argues that repos provide a vehicle by which the parties "divide" federal interest. Brief of Respondent at 31. Second, he argues from this premise that Nebraska's taxation

of distributed repo income "is a form of taxation which requires that the obligations, the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax." Brief of Respondent at 5. Third, Respondent contends that the economic substance of repo transactions should not govern taxability, but, rather, that the "parties' intent" should be respected. He further asserts that federal court precedents applying an economic substance test in analyzing the taxability of income from repos involving state and local obligations have been obviated by changes to the Internal Revenue Code, making "their rationale no longer viable under present law." Brief of Respondent at 35. Fourth, Respondent argues, for the first time, that Nebraska's taxation of repo income derived from federal obligations unconstitutionally discriminates against federal obligations. Finally, Respondent claims that Nebraska's tax would adversely affect the borrowing ability of the United States. None of these contentions have merit.

I. INCOME FROM REPURCHASE AGREEMENTS INVOLVING FEDERAL OBLIGATIONS DOES NOT CONSTITUTE AN "ALLOCATION" OR "DIVISION" OF INTEREST ON THE OBLIGATIONS PAID BY THE FEDERAL GOVERNMENT.

Respondent characterizes repos as "merely a way for multiple taxpayers to share income exempt from state taxation" and asserts that repos provide a means for parties to the repo transaction to "divide" federal interest. Brief of Respondent at 2, 31. Respondent's position is incorrect, as it is based on an erroneous characterization

of the nature and effect of transactions involving repurchase agreements.

The repos engaged in by the Trusts are agreements in which a party owning federal obligations and seeking cash, the seller-borrower/repurchaser, "sells" the obligations to the Trusts, the buyer-lender. The repo provides that the seller-borrower/repurchaser agrees to repurchase the obligations, and the buyer-lender agrees to resell the obligations, at a later date or on demand, plus an agreed upon rate of "interest" to be paid by the seller-borrower/repurchaser (J.A. 65-66). The "interest" paid by the seller-borrower/repurchaser is based on prevailing market rates paid on loans or financing transactions of similar maturity and risk; it does not bear any relationship to the interest rate or yield on the federal securities. *Matter of Bevill, Bresler & Schulman Asset Management Corp.*, 67 B.R. 557, 567 (D.N.J. 1986) ["*Bevill*"].

The "interest" received by the Trusts under their repos and distributed to Respondent is merely "interest" income paid to the Trusts by private party seller-borrower/repurchasers; it is not "interest" paid by the United States on the federal obligations. Indeed, the repo agreements entered into by the Trusts provide that any interest paid on the obligations during the term of the repurchase agreement must be paid to the seller-borrower/repurchaser (J.A. 69). Virtually every state court addressing the issue of the taxation of income from repos involving federal obligations distributed to mutual fund shareholders has held such income is not exempt under § 3124, as the Trusts do not receive interest income on the obligations, but, rather, receive "interest" paid by the seller-borrower/repurchaser at the rate agreed to by the

parties on the Trusts' loan to the seller-borrower/repurchaser. Brief of Petitioner at 31, n.15.[1]

The "interest" element in the Trusts' repurchase agreements does not in any sense represent interest paid by the United States on federal obligations. The "interest" represents the consideration paid by the seller-borrower/repurchaser to the Trusts for the use of funds which were, in essence, loaned to the seller-borrower/repurchaser by the Trusts. Such "interest" is not based on or otherwise attributable to interest paid on the obligations by the United States; rather, it is based on a rate agreed to by the parties, which reflects market interest rates for loans or financing transactions of comparable maturity and risk. The "interest" income received by the Trusts and distributed to Loewenstein was not interest paid by the federal government, and, therefore, does not constitute a "division" or "allocation" of interest on federal obligations.[2]

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[1] Respondent is therefore mistaken in his assertion that the $250 of interest received by Taxpayer 2 in his analysis involving a repurchase agreement at pages 28 through 31 of his brief is a "portion of the tax-exempt interest paid by the federal government [which] petitioner seeks to tax in violation of 31 U.S.C. § 3124 (1988)". Brief of Respondent at 29-30. The interest received by Taxpayer 2 in this hypothetical, as well as the interest received by the Trusts under their repos, is not any "portion" of "interest paid by the federal government". It is simply "interest" paid by the seller-borrower/repurchasers pursuant to the repo agreement.

[2] Respondent, at various points, refers to the Internal Revenue Code's treatment of debt instruments with "original issue discount" ("OID"). Brief of Respondent at 8, 27, 31; *see* I.R.C. §§ 1271 to 1276. Generally, the Code's OID rules require that the **holder** of a debt instrument issued with OID must include part of that OID in gross income as interest in each year it holds the

The fallacy of Respondent's position is evidenced by his analysis of various hypotheticals involving Nebraska's tax treatment of income under different scenarios. Brief of Respondent at 25-31. In the first scenario, a Nebraska taxpayer, Taxpayer 1, purchases a 360 day, $10,000 treasury bill for $9500. At maturity, the obligation is redeemed for $10,000, resulting in $500 of income taxable at the federal level. This income would be exempt from Nebraska income tax. Neb. Rev. Stat. § 77-2716(1)(a) (Supp. 1993). In the second scenario, Taxpayer 1, after holding the obligation for 180 days, sells the obligation to another Nebraska party, Taxpayer 2, for $9750. At maturity, the obligation is redeemed and Taxpayer 2 receives $10,000. In this case, Respondent asserts both Taxpayers derive federal taxable income of $250, and that the income received by each taxpayer would be exempt from

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debt instrument even though the OID is not paid until maturity. I.R.C. § 1271. Respondent's references to the OID provisions of the Code are inapposite for several reasons. First, the record does not reflect what portion, if any, of the "Eligible Securities" subject to the Trusts' repos involved federal obligations that were issued at a discount. The repo agreements do not specify that the securities must be obligations issued with discount. Second, the record reflects nothing as to how either the Trusts (or seller-borrower/repurchasers) report income for federal tax purposes. In any event, the OID provisions of the Code address only the accrual of interest income by the **holder** of debt instruments in a substantive sense. *See* B. Bittker and L. Lokken, ***Federal Taxation of Income, Estates and Gifts***, ¶ 56.4.2 (2d ed. 1989) (While "[n]either the statute nor the proposed regulations define the term 'holder' . . . , [p]resumably it refers to the person who is the owner of the obligations under general concepts of tax ownership."). Under this definition, the Trusts would not be the "holder" of federal obligations subject to repos, and, accordingly, the OID rules cited by Respondent are inapplicable.

Nebraska income tax. From these hypotheticals, Respondent makes four conclusions. The fourth conclusion Respondent draws, that "the total amount of income exempt from state taxation must equal the amount of interest paid by the federal government", however, does not follow with respect to his further analysis of the transaction involving the Taxpayers when engaging in a repurchase agreement. This analysis does not hold true where, as under a repurchase agreement, Taxpayer 1 has borrowed funds to acquire or hold the federal obligation, rather than engaging in an outright sale transferring the obligation to a second party.

To illustrate, assume that Taxpayer 1 borrowed $9500 from Taxpayer 2 to acquire the federal obligation, and agreed to pay Taxpayer 2 the principal amount plus $250 interest. The amount of income received by Taxpayer 1 on redemption ($500) would be offset by the amount of this interest expense, resulting in federal taxable income of $250 to Taxpayer 1. Taxpayer 2 would also have $250 of federal taxable income, reflecting the amount of interest received pursuant to the loan agreement. For Nebraska tax purposes, Taxpayer 1 would receive an adjustment reducing taxable income by $250, the net amount included in federal taxable income Neb. Rev. Stat. § 77-2716(1)(e)(i) (Supp. 1993). Taxpayer 1 therefore has no Nebraska taxable income. Taxpayer 2 would have $250 of income taxable at the state level resulting from Taxpayer 1's repayment of the principal plus interest pursuant to the loan agreement.

Under Respondent's view, the $250 of income received by Taxpayer 2 under this loan agreement must be exempted from state taxation because the entire

amount of interest paid by the federal government is not reflected as an adjustment for interest paid on a federal obligation on the Nebraska returns of Taxpayer 1 and Taxpayer 2. This is not true where, as in this example, the owner of a federal obligation has borrowed funds to acquire or hold the obligation. Nor is it true in the instant case, where the Trusts received income from seller-borrower/repurchasers, which was distributed to Respondent, based on a rate of interest paid to the Trusts under repos secured by federal obligations, and not interest income paid by the federal government on federal obligations. Respondent in essence argues that Nebraska must, under § 3124, exempt distributed income received by the Trusts under repos secured by federal obligations as the equivalent of interest paid on the obligations by the federal government. Section 3124 does not require this result.

II. NEBRASKA'S TAX ON REPO INCOME DISTRIBUTED TO MUTUAL FUND SHAREHOLDERS DOES NOT CONSIDER, DIRECTLY OR INDIRECTLY, FEDERAL OBLIGATIONS OR THE INTEREST ON FEDERAL OBLIGATIONS.

Section 3124, by its terms, prohibits only any "form of state taxation that would require the [United States government] obligation, the interest on the obligation, or both, to be considered in computing a tax. . . . " 31 U.S.C. § 3124(a). The statute means that a state may not "take[ ] into account, or include[ ] in the accounting" the value of the federal obligation itself or the interest on that obligation in determining tax liability. *American Bank and Trust Co. v. Dallas County*, 463 U.S. 855, 862 (1983).

Computation of Nebraska's tax on distributed repo income received by Loewenstein did not require consideration of any federal obligation or the interest on any federal obligation. Repo income earned by the Trusts was received from private party seller-borrower/repurchasers to compensate the Trusts for the use of funds provided by the Trusts. The repo "interest" rate was not related to the yield or interest rate of the federal obligation, but was based on the market rate for loans or financing transactions of similar maturity and risk. Repo income is the amount paid by the seller-borrower/repurchaser to the Trusts for the use of money; it is not interest income paid on federal obligations by the federal government.

In arguing that § 3124 mandates that Nebraska exempt repo income, Respondent refers to the Court's language in *American Bank and Trust Co. v. Dallas County*, that the exemption is "sweeping: with specific exceptions, it 'extends to *every form* of taxation that would require that either the obligations or the interest thereon, or both, *be considered, directly or indirectly, in the computation* of the tax' (emphasis supplied)". 463 U.S. at 862 (*citing Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 395-96 (1983)). Nebraska's tax, however, does not even "indirectly" consider a federal obligation or the interest on a federal obligation in its computation. Both Respondent and the court below would extend the exemption beyond its statutory context to read the term "indirectly" as a ban on any form of state tax on income which is somehow "indirectly" connected to a federal obligation. Income received by the Trusts and distributed to Respondent is not even remotely connected to a federal obligation; in no way is it the interest paid by the federal government on a federal

obligation. Respondent's position, adopted by the Nebraska Supreme Court, is contrary to the Court's recognition that the 1959 amendment placing this language in the statute "did not broaden the scope of the exemption beyond that mandated by the Constitution", *First Nat'l Bank of Atlanta v. Bartow Cty. Bd. of Assrs.*, 470 U.S. 583, 593 (1985), but was only "intended to abolish the formalistic distinction between **taxes on** income and taxes **measured by** income" *Id.* at 594 (emphasis in original). The income subject to Nebraska tax is interest paid by private party seller-borrower/repurchasers for the use of funds provided by the Trusts. The tax does not "consider" a federal obligation or the "interest" on a federal obligation within the meaning of § 3124.[3]

Loewenstein continues to misconstrue the language of § 3124 by asserting the statute mandates the exemption of "income" derived from transactions "in consideration of [ ] federal obligations." Brief of Respondent at 7. The statute prohibits only state taxes which, in their computation, consider a federal obligation or the interest paid by the federal government on the obligation. Nebraska's tax does neither.

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[3] Even if the Court were to recognize the repo transactions involving the Trusts as true sales and repurchases, this would not lead to the conclusion that Nebraska's tax violates § 3124. Section 3124 does not immunize from state taxation "owners" of federal obligations. The exemption required by § 3124 extends only to taxes the computation of which require consideration of a federal obligation or the interest on the obligation. The income received by the Trusts under its repo agreements came from neither of these sources; rather, it was income received by the Trusts resulting from the other party's payment of "interest" for the use of funds for a certain period of time.

III. THE ECONOMIC SUBSTANCE OF REPURCHASE TRANSACTIONS SHOULD DETERMINE THE TAXABILITY OF REPO INCOME.

Respondent contends that the economic substance of repo transactions should not govern taxability, but, rather, that the "parties' intent" should be respected. He also asserts that federal court precedents applying an economic substance test in analyzing the taxability of income from repos involving state and local obligations have been obviated by changes to the Internal Code, making "their rationale no longer viable under present law." Brief of Respondent at 35. Respondent is wrong on both counts.

The Court has long recognized that the economic substance of a transaction controls its tax treatment rather than the form that the transaction takes. "In the field of taxation, administrators of the laws and the courts are concerned with substance and realities. . . . " *Helvering v. F & R Lazarus & Co.*, 308 U.S. 252, 255 (1939). *See also Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 266-67 (1958) (substance, not form of transactions, is controlling; "[t]heir essence is determined not by subtleties of draftmanship but by their total effect").

In support of his claim, Respondent relies principally on this Court's decision in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978). In *Frank Lyon Co.*, the Court considered the federal income tax treatment of a sale and leaseback transaction in which Frank Lyon Company took title to a building under construction by a second entity, and simultaneously leased the building back to that entity for long-term use. The Commissioner determined that Frank

Lyon Co. did not possess ownership of the building for tax purposes, and denied income tax deductions taken by the Company for expenses related to the building. *Id.* at 562, 568. The Court rejected the Government's claim that "[a]lthough the arrangement was cast in sale-and-leaseback form, in substance it was only a financing transaction", and that the transaction should "be regarded as a sham." *Id.* at 573. The Court held

> that where, as here, there is a genuine multiple-party transaction **with economic substance** which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

Id. at 583-84 (emphasis added). The Court admonished, however, "that we are not condoning manipulation by a taxpayer through arbitrary labels and dealings that have no economic significance." *Id.* at 583.

Frank Lyon Co. provides little support for Respondent's position. The Court in that case found that the transaction at issue did, in fact, have true "economic substance". Here, in contrast, the repo agreements entered into by the Trusts do not, by their terms, possess true "economic substance" as purchases and sales of federal obligations. The terms of the "General Repurchase Agreement" used by the Trust when engaging in repos illustrate that, in economic substance, the transactions were loans by the Trusts to the seller-borrower/repurchasers in which federal obligations functioned as

collateral (J.A. 65-71; Brief of Petitioner at 27-29). Virtually every state court addressing the taxability of repo income has determined that, in economic substance, the transactions are secured loans in which federal obligations serve as collateral, and the interest received by the buyer-lender is "interest" on the loan paid by the seller-borrower/repurchaser at the rate agreed to by the parties, not interest paid by the federal government on the obligations. Brief of Petitioner at 25-31, n.15. These courts properly recognized that substance, not form, is the relevant inquiry in determining the taxability of repo income under § 3124.[4]

Respondent further argues that federal court precedents applying an economic substance test in analyzing the taxability of income from repos involving state and local obligations have been obviated by changes to the

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[4] Respondent makes reference to opinions by the Attorneys General of several states discussing the authority of state officials to engage in repo transactions and whether those transactions violated state constitutional provisions against lending the credit of the state. Brief of Respondent at 20-25. Petitioner has previously acknowledged that repo transactions may be characterized differently depending on the context in which they are considered. Brief of Petitioner at 22 n.10. In tax cases, however, repos should be judged by their substance, not mere form. Moreover, as noted by amicus curiae Investment Company Institute ["ICI"] and the Federal Reserve Bank of New York ["FRBNY"], the terms of repo agreements outside the mutual fund context may be different than the terms under which the Trusts engaged in repos. Brief of Amicus Curiae ICI at 18; Brief of Amicus Curiae FRBNY at 4 & n.3. There is nothing to indicate that the repurchase agreements addressed in the opinions of the several state Attorneys General cited by Respondent resemble the agreements entered into by the Trusts.

Internal Revenue Code, making their "rationale no longer viable under present law." Brief of Respondent at 35.[5] Respondent misconstrues the effect of the amendments to the federal tax code, and their asserted impact on the continued vitality of these federal court cases.

Prior to 1982, financial institutions generally could hold exempt obligations without losing a deduction for interest paid on their deposits. *See* Rev. Rul. 61-222, 1961-C.B. 58. As Respondent notes, § 902 of the Tax Reform Act of 1986 added I.R.C. § 265(b), which generally disallows any deduction to financial institutions for interest allocable to tax exempt obligations.

What Respondent fails to recognize, however, is that *Union Planters* and other federal court decisions relied upon by Petitioner did not hinge on the application of § 265 to **banks**. Rather, the courts determined in these cases that, while the banks actually received interest on the municipal obligations under their repo arrangements with bond dealers, the true economic substance of the transactions was that the banks were not the owners of the obligations, and were therefore not entitled to the exemption from federal taxation under I.R.C. § 103. The bond dealers could not, under § 265, deduct interest incurred to purchase or carry tax exempt obligations. Thus, the interest income received by the banks was, in essence, imputed to the dealers; the amounts received by

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[5] *American Nat'l Bank v. United States*, 421 F.2d 447 (5th Cir.), *cert. denied*, 400 U.S. 819 (1970); *First American Nat'l Bank v. United States*, 467 F.2d 1098 (6th Cir. 1972); *Union Planters Nat'l Bank v. United States*, 426 F.2d 115, (6th Cir.), *cert. denied*, 400 U.S. 827 (1970).

the banks were therefore treated as interest payments from the dealers to the banks, not interest paid by the municipalities issuing the obligations. Contrary to Respondent's claim, *Union Planters* and other federal court decisions applying an economic substance test in analyzing repo transactions involving state and local obligations are still relevant in determining the question presented.[6]

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[6] Respondent misconstrues Nebraska's reference to the "double tax benefit" which would occur if income from repos involving federal obligations is exempted from state taxation under § 3124. The "double tax benefit" arises because Respondent (or, more accurately, the Trusts), do not own the federal obligations. The seller-borrower/repurchaser is the substantive owner of the obligations and is entitled to the interest on the obligations. The substantive owner is entitled to the exemption from state taxation for such interest. If, however, as in the case of a repurchase agreement, the seller-borrower/repurchaser incurs interest expense to carry the obligations, this will reduce the economic benefit of the exemption from state taxation. This is the result of Neb. Rev. Stat. § 77-2716(1)(e)(i) (Supp. 1993), the state law counterpart to I.R.C. § 265. Any diminution of the amount of the exemption, however, is the result of the borrowing engaged in by the seller-borrower/repurchaser. Requiring exemption of interest paid by the seller-borrower/repurchaser to the Trusts would result in the extension of the exemption under § 3124 to interest paid not by the federal government on its obligations, but to interest paid by a private party which has no connection whatsoever to interest on the federal obligations. It is this extension of § 3124 urged by Respondent, which would require Nebraska to provide an exemption for income earned by the Trusts and distributed to Respondent resulting from interest payments by the owner of federal obligations from loans secured by federal obligations, which constitutes an additional and unwarranted "double tax benefit".

IV. NEBRASKA'S TAXATION OF REPO INCOME DOES NOT DISCRIMINATE AGAINST FEDERAL OBLIGATIONS.

Respondent, for the first time, argues that Nebraska's tax is invalid because it discriminates against federal obligations in favor of state and local obligations. Brief of Respondent at 35-37. Nothing in the record supports this contention.

Petitioner acknowledges that the Court has struck down state taxes which discriminated against the federal government. *Barker v. Kansas*, ___ U.S. ___, 112 S. Ct. 1619 (1992) (state could not constitutionally tax U.S. military retirement benefits while not taxing state and local government retirement benefits); *Davis v. Michigan Dept. of Treasury*, 489 U.S. 803 (1989) (state could not exempt retirement benefits paid to state employees while taxing retirement benefits paid by all other employers, including the federal government); *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983) (state could not include income from federal obligations in computation of bank tax while excluding income from state's own obligations). Respondent argues that, because Nebraska has no statute, revenue ruling, or regulation specifically addressing the taxability of repo income derived from state and local obligations (including Nebraska obligations), Nebraska's tax treatment of repo income distributed to Respondent by the Trusts impermissibly discriminates against federal obligations.

Contrary to Respondent's claim, no such discrimination exists. Repos involving state and local obligations, including Nebraska obligations, are treated the same. It is

true that, by statute, Nebraska does not require that income earned on Nebraska obligations be added back in determining Nebraska taxable income. Neb. Rev. Stat. § 77-2716(1)(c) (Supp. 1993). This does not, of course, establish that Nebraska treats income derived from repos involving state and local obligations, including Nebraska obligations, differently than it does income derived from repos involving federal obligations. Only interest income on Nebraska based obligations is addressed by § 77-2716(1)(c). Repo income, however, whether derived from transactions involving federal or state and local obligations (including Nebraska obligations), is not, for Nebraska tax purposes, considered interest paid on the underlying obligations, but, rather, is interest paid by the seller-borrower/repurchaser pursuant to repo agreements. Respondent, by interjecting this issue at this time, seeks to require Nebraska to prove a negative, i.e., that Nebraska discriminates in its treatment of repo income involving federal obligations because the particular Revenue Ruling at issue discusses only repo income derived from federal obligations. Nothing in the record supports Respondent's claim, and, in actuality, no such discriminatory treatment exists.

V. NEBRASKA'S TAX ON REPO INCOME DOES NOT DIMINISH THE MARKETABILITY OF FEDERAL OBLIGATIONS AND DOES NOT IMPAIR THE BORROWING ABILITY OF THE UNITED STATES.

Finally, Respondent continues to rely, as did the court below, on the deposition testimony of Peter D. Sternlight, former executive vice president of the Federal Reserve Bank of New York, in an attempt to establish that

Nebraska's tax would unconstitutionally diminish the marketability of federal obligations and impair the borrowing ability of the United States. Brief of Respondent at 39-40.

Nebraska has addressed at length the misapplication by the court below of the testimony of Mr. Sternlight. Brief of Petitioner at 42-45. In sum, Mr. Sternlight's testimony, contained in his affidavit submitted in a bankruptcy case, does not reflect any opinion or view as to the impact of state taxation of repo income on the investment attractiveness of federal obligations, nor does he opine that state taxation of repo income would impede the borrowing ability of the United States. Significantly, while not mentioned by Respondent, Nebraska's view of the misapplication of Mr. Sternlight's testimony by the court below is confirmed by amicus curiae the Federal Reserve Bank of New York. Brief of Amicus Curiae FRBNY at 8-10. FRBNY states that "[t]he *Loewenstein* court relief upon Mr. Sternlight's statements but appeared to have drawn some inferences from them that Mr. Sternlight did not intend and are unwarranted." Brief of Amicus Curiae FRBNY at 9. FRBNY specifically acknowledges that "[t]he Sternlight Affidavit does not mention taxes. Nor did Mr. Sternlight testify about taxes in his deposition." *Id.*

The Court has refused to find a prohibited effect on the marketability of federal obligations absent supporting evidence. *See First Nat'l Bank of Atlanta v. Bartow Cty. Bd. of Assrs.*, 470 U.S. 583, 597 (stating there was no evidence that removal of a tax shelter would "prompt banks to forgo the advantages of federal obligations, such as their extreme liquidity and safety, and to invest their money

elsewhere."). The same principle is applicable in this case. There is no evidence that Nebraska's taxation of repo income distributed to Respondent will have the deleterious effects on the marketability or attractiveness of federal obligations asserted by Respondent.

CONCLUSION

The decision of the Supreme Court of Nebraska should be reversed.

Respectfully submitted,

STATE OF NEBRASKA,
DEPARTMENT OF REVENUE,
Petitioner,

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Pursuant to Rule 37.4 of the Rules of this Court, *amici* respectfully move this Court for leave to file the attached brief *amicus curiae* in support of petitioner. Petitioner has consented to the filing of this brief. This motion is made necessary by the refusal of respondent to consent to the filing.

Amici are organizations whose members include state, county, and municipal governments and officials throughout the United States. *Amici* have a compelling interest

in legal issues that affect state and local governments. Among the most important of such issues are those involving the scope of federal limitations on state and local taxing authority. The Nebraska Supreme Court's reading of 31 U.S.C. § 3124 would prohibit state taxation of mutual fund income derived from repurchase agreements involving federal securities, and would thereby eliminate a source of tax revenue currently relied upon by many States.* Moreover, the Nebraska Supreme Court's interpretation would stretch the doctrine of intergovernmental tax immunity to unprecedented lengths by extending it to taxes that consider neither a federal obligation nor interest on a federal obligation.

Because *amici* and their members have a compelling interest in these issues, *amici* submit this brief to assist the Court in its resolution of this case.

Respectfully submitted,

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May 3, 1994

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* Express judicial or administrative authority supports the taxation of repurchase income in many States. *See, e.g., Department of Revenue v. Page*, 541 So.2d 1270 (Fla. Dist. Ct. App. 1989); *Andras v. Illinois Dep't of Revenue*, 506 N.E.2d 439 (Ill. App. Ct. 1987), *cert. denied*, 485 U.S. 960 (1988); *Hammond Lead Products v. State of Indiana Tax Comm'rs*, 575 N.E.2d 998 (Indiana 1991); *Everett v. Department of Revenue and Finance*, 470 N.W.2d 13 (Iowa 1991); *Comptroller v. First United Bank*, 578 A.2d 192 (Md. 1990); Massachusetts Ltr. Rul. 81-82 (Sept. 1, 1981), 1991 Mass. Tax LEXIS 39; Michigan Ltr. Rul. 87-68 (June 6, 1987), 1987 Mich. Tax LEXIS 114; *Massman Constr. v. Director of Revenue*, 765 S.W.2d 592 (Mo. 1989); *Trust for Short-Term U.S. Government Securities v. Minnesota Dep't of Revenue*, No. 89-1317 (Dist. Ct. Hennepin County 1989); New York Tech. Servs. Mem. TSB-M-88-(5)I (June 8, 1988), *cited in* TSB-A-89-(4)I, 1989 N.Y. Tax LEXIS 311; N.C. Admin. Code tit. 17, r. 06B.0116(1); *Pastore v. Limbach*, Ohio Bd. of Tax Appeals, No. 89-G-310 (May 3, 1991), *reprinted in* 27 Ohio Tax Reports (CCH) ¶ 400-916 (Sept. 16, 1991), 1991 Ohio Tax LEXIS 835; Oklahoma Tax Comm'n 89-09-26-16/Prec. (Sept. 26, 1989), 1989 Okla. Tax LEXIS 24; *Borg v. Department of Revenue*, 774 P.2d 1099 (Or. 1989); South Carolina Rev. Rul. 91-15 at 6-7 (Sept. 18, 1991), 1991 S.C. Tax LEXIS 58; *Capital Preservation Fund, Inc. v. Wisconsin Dep't of Revenue*, 429 N.W.2d 551 (Wis. App. 1988); *In re Thomas C. Sawyer Estate*, 546 A.2d 784 (Vt. 1987); *Re: Ruling Request—Exempt Interest and Dividends*, P.D. 87-186 (Cir. Ct. Buchanan County, Va.) (July 7, 1987), 1987 Va. Tax LEXIS 107.

The Federation of Tax Administrators anticipates publishing a report containing complete data on state tax treatment of repurchase agreement income received through mutual funds. Federation of Tax Administrators, *State Taxation of Income from Mutual Funds or Money Market Accounts Invested in U.S. Government Securities: A Revised Report* (forthcoming Summer 1994).

QUESTION PRESENTED

Whether a state tax imposed on mutual fund shareholder income derived from repurchase agreements involving federal securities violates 31 U.S.C. § 3124 or the constitutional doctrine of intergovernmental tax immunity.

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IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

No. 93-823

STATE OF NEBRASKA, DEPARTMENT OF REVENUE,
Petitioner,
v.
JOHN LOEWENSTEIN,
Respondent.

On Writ of Certiorari to the Supreme Court of Nebraska

BRIEF OF THE COUNCIL OF STATE GOVERNMENTS, NATIONAL CONFERENCE OF STATE LEGISLATURES, INTERNATIONAL CITY/COUNTY MANAGEMENT ASSOCIATION, NATIONAL LEAGUE OF CITIES, NATIONAL ASSOCIATION OF COUNTIES, U.S. CONFERENCE OF MAYORS, AND NATIONAL GOVERNORS' ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

INTEREST OF THE *AMICI CURIAE*

The interest of the *amici* is set forth in the motion accompanying this brief.

STATEMENT

Amici adopt petitioner's statement of the case, and provide only the following discussion of points relevant to *amici*'s argument.

A repurchase agreement or "repo" is a two step transaction, both parts of which are agreed to by the parties at the outset. *See* J.A. 11-12 ¶¶ 10-12. In the first step, Party A provides funds to Party B, in exchange for securities owned by B. J.A. 11 ¶ 11.[1] The amount which A gives B is typically less than the amount the securities owned by B are actually worth. Marcia Stigum, *The Money Market* 580 (3d ed. 1990); J.A. 12 ¶¶ 15-17; J.A. 33-34. In step two, A returns the securities to B, and B returns the funds to A, along with "interest"—an amount representing the value of B's use of the funds for the elapsed period of time. Stigum, *The Repo and Reverse Markets* at 26; J.A. 12 ¶ 12. This "interest" is the repo income which Nebraska, like most other States, seeks to tax.

The rate of interest paid in connection with the repurchase transaction "does not bear any relationship to the interest rate or yield paid on the underlying security, but rather is based on the prevailing market rate paid on investments or financing transactions of similar maturity and risk." *In re Bevill, Bresler & Schulman Asset Management Corp.*, 67 B.R. 557, 567 (D.N.J. 1986). The interest paid on the securities themselves by the federal government is at all times considered the income of the original owner of the securities. If the lender/buyer receives such interest on the securities during the repurchase term, it is handed over to the original owner. *See* Stigum, *The Repo and Reverse Markets* at 319; J.A. 69 ¶ 9.

Although denominated a "repurchase," there is general agreement throughout the financial community that the transaction operates, in economic essence, like a collateralized loan. *See, e.g.*, Stigum, *The Money Market*

[1] Although the securities involved in this case are federal securities, municipal bonds and other instruments may also be the subject of repurchase agreements. *See* discussion *infra* at 24-26; Marcia Stigum, *The Repo and Reverse Markets* 333-34 (1989) (discussing litigation involving municipal bond repos); Marcia Stigum, *The Money Market* 587 (3d ed. 1990).

at 577 ("Despite the fact that repos and reverses take the form of sequential sales and repurchases of securities, everyone on the Street agrees that the *economic essence* of the transaction is that it is a *collateralized loan*, not a pair of securities trades.").

The Federal Reserve Board participates in repurchase agreements to effect short-term adjustments in the nation's money supply. *See generally* Marcia Stigum, *The Repo and Reverse Markets* 90-96 (1989); William F. Hagerty, IV, Note, *Lifting the Cloud of Uncertainty Over the Repo Market: Characterization of Repos as Separate Purchases and Sales of Securities*, 37 Vand. L. Rev. 401, 403-04 (1984). Repurchase agreements which do not involve the Fed, however, do not serve this purpose. Such repos are viewed as alternatives to other forms of credit for the parties involved, and are used either to obtain the use of funds for a short time period, or to invest funds for short-term use by another party. *See* Stigum, *The Repo and Reverse Markets* at 107-110, 312-313; Hagerty, *Lifting the Cloud of Uncertainty*, 37 Vand. L. Rev. at 404.

This case involves Nebraska's efforts to tax income derived from private repurchase agreements entered into by two mutual funds, the Trust for Short Term U.S. Government Securities and the Trust for U.S. Treasury Obligations (the "Trusts"). Pet. 2-3. There has been no suggestion that the Fed was a party to any of the repurchase agreements at issue here. Indeed, Loewenstein describes the Trusts in which he invested as "secondary dealers," *see* Opp. 8; such "secondary dealers do not deal directly with the Federal Reserve." *Bevill*, 67 B.R. at 568; *see* Opp. 8.

SUMMARY OF ARGUMENT

1. Section 3124 prohibits any form of state taxation that "would require the [federal] obligation, the interest on the obligation, or both, to be considered in computing a tax . . . ." 31 U.S.C. § 3124(a). The tax which Nebraska has imposed upon mutual fund income derived from repurchase agreements involving federal securities falls outside the scope of this prohibition, because it does not consider the underlying federal obligation or interest paid on that obligation. Instead, the income earned in connection with a repurchase agreement represents the value associated with the use of a sum of money for a given period of time. *See* Stigum, *The Repo and Reverse Markets* at 26 ("The difference between the purchase and sale prices on the repo transaction is the interest the investor earns on his loan.").

Whether a repurchase agreement is characterized in accordance with its clear economic purpose and effect (*i.e.*, as a loan collateralized by a federal obligation), or viewed as unique hybrid transaction that involves a matched sale and repurchase designed to achieve the same effect as a loan, money paid in connection with a private repo reflects one thing only—the value associated with the use of a sum of money for an agreed period of time. By construing Section 3124 to exempt income from such private transactions from state taxation, the Nebraska Supreme Court flatly disregarded this Court's repeated admonition that the statutory exemption not be "expanded or modified in any degree by the judiciary[.]" *Rockford Life Ins. Co. v. Illinois Dep't of Revenue*, 482 U.S. 182, 191-92 (1987) (quoting *Smith v. Davis*, 323 U.S. 111, 119 (1944)).

2. Respondent relies on an erroneous interpretation of language in *Smith* to argue that repo income is entitled to tax-exempt status under Section 3124. There, in assessing the types of government obligations encompassed within Section 3124's prohibition, the Court noted

"the long established Congressional intent to prevent taxes which diminish in the slightest degree the market value or investment attractiveness of obligations issued by the United States in an effort to secure necessary credit." 323 U.S. at 117. Respondent's attempt to translate that statement into a ban on state taxation of repo income is unavailing for two reasons.

First, no evidence has been presented in this case that would indicate a State's taxation of repo income would have any deleterious effect on the "market value" or "investment attractiveness" of federal obligations. The affidavit of Peter D. Sternlight, upon which respondent and the Nebraska Supreme Court place primary reliance, *see* Opp. 7-9 & App. A; Pet. App. 7-8, was prepared for a bankruptcy proceeding and contains no evidence whatsoever as to the effect of state taxation on the repo market, and offers no opinion on that subject. Moreover, because repos are uniquely attractive investment instruments which have no close substitutes, it is unlikely that state taxation would cause investors to turn away from them in sufficient numbers to have any impact on the market for the underlying federal obligations.

Second, respondent's reading of the statement in *Smith* is inconsistent with precedents of this Court, both before and after *Smith*, holding that an attenuated or indirect effect on the federal government's borrowing power is insufficient to confer immunity from taxation. *See, e.g., Rockford*, 482 U.S. at 190. Moreover, the Court has repeatedly declined to read intergovernmental tax immunity doctrines as sheltering otherwise taxable income. *See, e.g., First Nat'l Bank of Atlanta v. Bartow County Bd. of Tax Assessors*, 470 U.S. 583, 595-96 (1985). The Court has never required States to go beyond the statutory and constitutional requirements to grant additional tax advantages to holders of federal securities and those with whom they deal; failure to grant such added advantages does not "diminish" the attractiveness of the obligations in the sense prohibited by Section 3124.

3. Granting tax-exempt status to repo income involving federal obligations will create a double standard in violation of principles of intergovernmental tax immunity unless repo income involving municipal bonds is similarly exempted from federal taxation. In analyzing assertions of tax immunity involving either the federal government or state and local governments, the Court uses the same standard to determine "whether a tax is 'on' a government." *South Carolina v. Baker*, 485 U.S. 505, 518 n.11 (1988). Hence, if principles of intergovernmental tax immunity are held to require the serious encroachment on the taxing power of the States urged by respondent, they would also necessarily require that the same limitation be placed on the taxing power of the federal government where repos involving municipal bonds are concerned, thereby calling into question the validity of a line of federal appellate cases holding to the contrary.

ARGUMENT

STATUTORY AND CONSTITUTIONAL PRINCIPLES OF INTERGOVERNMENTAL TAX IMMUNITY DO NOT PROHIBIT STATES FROM TAXING INCOME OF MUTUAL FUND SHAREHOLDERS DERIVED FROM REPURCHASE AGREEMENTS INVOLVING FEDERAL SECURITIES

The modern doctrine of intergovernmental tax immunity rests on the core tenet that "absent congressional action, we have emphasized that the States' power to tax can be denied only under 'the clearest constitutional mandate.'" *United States v. New Mexico*, 455 U.S. 720, 738 (1982) (quoting *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 293 (1976)). Because the Court has indicated that Congress' enactment of Section 3124 did not expand the reach of intergovernmental tax immunity beyond its narrow constitutional confines,[2] before examining that

[2] The prior codification of Section 3124 was viewed as coextensive with the constitutional doctrine of intergovernmental tax immunity. *See, e.g., First Nat'l Bank*, 470 U.S. at 593 ("[T]his Court consistently has 'treated [§ 3701] as principally a restatement of the constitutional rule.'") (citations omitted). The legislative history of the statutory provision's 1982 recodification as Section 3124 indicates that no substantive change was intended. *See id.* at 585 n.1; H.R. Rep. No. 651, 97th Cong., 2d Sess. 94, *reprinted in* 1982 U.S.C.C.A.N. 1895, 1988.

statute it is appropriate to revisit "the underlying constitutional principle" which it embodies. *New Mexico*, 455 U.S. at 733. That principle, as the Court has emphasized, exists within "narrow constitutional limits," *id.* at 737, and serves a very specific, limited purpose—"that of forestalling 'clashing sovereignty,' by preventing the States from laying demands directly on the Federal Government." *Id.* at 735 (quoting *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 430 (1819)). Accordingly, the Constitution prohibits only those taxes which "would be 'a direct interference with the functions of government itself.'" *Id.* at 736 (quoting *James v. Dravo Contracting Co.*, 302 U.S. 134, 157 (1937)).

This "narrow approach to governmental tax immunity accords with competing constitutional imperatives, by giving full range to each sovereign's taxing authority." *Id.* at 735-36. And, as the Court explained in the landmark case of *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466 (1939), a narrow construction of intergovernmental tax immunity is especially important to avoid unwarranted encroachment on the taxing power of the other sovereign, where, as here, the principle of intergovernmental tax immunity is invoked for the benefit of a private citizen:

> [T]he implied immunity of one government and its agencies from taxation by the other should, as a principle of constitutional construction, be narrowly restricted. For the expansion of the immunity of the one government correspondingly curtails the sovereign power of the other to tax, and where that immunity is invoked by the private citizen it tends to operate for his benefit at the expense of the taxing

government and without corresponding benefit to the government in whose name the immunity is claimed.

Id. at 483 (citations omitted). Here, the encroachment on the taxing power of the States proposed by respondent cannot be squared with this limited constitutional principle of intergovernmental tax immunity. Because Section 3124 is no broader in scope than this underlying constitutional principle, an analysis of the Nebraska tax under this statute yields the same conclusion.

A. State Taxes Imposed On Mutual Fund Income Derived From Repurchase Agreements Do Not Violate Section 3124, Because Their Computation Does Not Require Consideration Of A Federal Obligation Or The Interest On A Federal Obligation

Section 3124 clearly defines the scope of the tax exemption at issue here: A state or local government is prohibited from imposing any "form of taxation that would require the [United States government] obligation, the interest on the obligation, or both, to be considered in computing a tax . . . ." 31 U.S.C. § 3124(a). The plain meaning of this statutory provision is that a state or local government may not "take[] into account, or include[] in the accounting" the value of the federal obligation itself or the interest earned on that obligation in determining tax liability. *American Bank and Trust Co. v. Dallas County*, 463 U.S. 855, 862 (1983).

Computation of the Nebraska tax on Loewenstein's income does not require consideration of any federal obligation or the interest on any federal obligation. Income derived from repurchase agreements is paid for the use of money for a specified time period, and is unrelated to the yield or interest rate of the underlying security. *See* Stigum, *The Repo and Reverse Markets* at 318; *Bevill*, 67 B.R. at 567. Repo income represents a sum paid for the use of the money, not interest paid by the federal government on the underlying exempt obligation. Even during the repurchase term, the interest paid on the federal obligation itself (which is, of course, not subject to taxation by Nebraska) is passed through to the original owner of the securities. *See* Stigum, *The Repo and Reverse Markets* at 319; J.A. 69 ¶ 9. In private repos, such as the ones implicated here, the transaction is designed to do nothing more than permit one party to have the use of a given sum of money for a specified period of time. *See* page 3, *supra*; Stigum, *The Repo and Reverse Markets* at 107-110.

Whatever its form, the economic substance of a repurchase, like that of any arrangement designed to allow one party to use funds provided by another party for a given period of time, is a loan. *See, e.g.*, Stigum, *The Money Market* at 577; J.A. 30 (Sternlight deposition); Elizabeth M. Osenton, Note, *The Need For A Uniform Classification Of Repurchase Agreements: Reconciling Investor Protection With Economic Reality*, 36 Am. U. L. Rev. 669, 689 (1987). The federal obligation is not "purchased" or "sold" in any economically meaningful sense; instead, it serves as collateral for a loan. This becomes clear when key factors such as the risks borne by each party, the "sales" price, the amount of "interest" paid, and the treatment of interest on the underlying security, are considered. The way in which these features are handled in the repurchase transaction is economically explicable only when the transaction is viewed as a collateralized loan. *See, e.g.*, Stigum, *The Repo and Reverse Markets* at 311-32; Pet. Br. at 23-32.[3]

[3] Even if the Court were to view the repurchase agreement as a purchase and sale of a federal obligation, however, Loewenstein would still not be entitled to a tax exemption. If the transaction were characterized in this manner, the difference between the amount he initially "paid" for the federal security and the amount he ultimately "sold" it back for would represent a capital gain. Capital gains on federal obligations are not tax exempt. Because such "gain[s] may be regarded as 'the creation of capital, industry and skill,'" a tax on them is not "on the obligations of the [government], or on the investment therein" and does not violate principles of intergovernmental tax immunity. *Willcuts v. Bunn*, 282 U.S. 216,

As this Court has noted, it is the economic substance of a transaction that controls its treatment for tax purposes rather than the form that the transaction takes. "In the field of taxation, administrators of the laws and the courts are concerned with substance and realities . . . ." *Helvering v. F & R Lazarus & Co.*, 308 U.S. 252, 255 (1939). *See also Commissioner of Internal Revenue v. P.G. Lake, Inc.*, 356 U.S. 260, 266-67 (1958) (substance of arrangements controls rather than form; "[t]heir essence is determined not by subtleties of draftsmanship but by their total effect"); *Gregory v. Helvering*, 293 U.S. 465, 469-70 (1935). This is consistent with Congress' rejection, in the field of intergovernmental tax immunity, of formal distinctions that are economically meaningless. *See American Bank and Trust Co.*, 463 U.S. at 862.

But whether or not the characterization of a repurchase agreement as a collateralized loan is accepted, the fact remains that repo income does not represent a federal obligation or its interest, but income from a private transaction for the use of money for a given period of time. Hence, even if this Court were to decide that a repurchase is better characterized as a purchase and resale, rather than a loan, this characterization would not be determinative for Section 3124 purposes. Section 3124 does not provide a blanket immunity from taxation for "owners" of federal securities; even an "owner" of a federal security is only entitled to exemption from taxes the computation of which requires consideration of the federal security or the interest earned thereon. Regardless of how a repo is characterized, the income that it generates stems from neither of these sources; instead it is money that one party pays another for the privilege of using money for a certain time period.

In arguing that Section 3124 nevertheless requires that a tax exemption be granted repo income, respondent, like

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228 (1931) (citation omitted); *see* Br. *Am. Cur.* State of California, *et al.* at 13-17.

the Nebraska Supreme Court, relies on the statute's prior wording, which expressly banned every form of taxation that required the federal obligation or interest on the obligation to "be considered, directly or indirectly, in the computation of the tax . . . ." *See* Pet. App. 9; Opp. 10. This language, which was added in a 1959 amendment, did away with formalistic distinctions having no basis in economic reality, so as to ban taxes which were, in economic effect, placed upon federal securities or the interest earned thereon. *See American Bank*, 463 U.S. at 858, 862. Because Congress indicated that its 1982 recodification of the statute (which omitted the words "directly or indirectly") was intended to work no substantive change, *see* note 2, *supra*, respondent is correct in asserting that Section 3124 continues to ban forms of taxation that require the "indirect" consideration of a federal security or the interest thereon.

Here, however, computation of Nebraska's tax does not involve even the "indirect" consideration of a federal security or interest on a federal security—the interest paid in connection with a repurchase is paid for use of a sum of money for a period of time and represents neither a federal security nor its interest or yield. The Nebraska Supreme Court reached the opposite result only by stripping the word "indirectly" of its statutory context and reading it as an open-ended ban on any tax placed on income even "indirectly" linked to a federal obligation. As the Court made clear in *First National Bank*, however, the words "directly or indirectly" were not intended to "broaden the scope" of the statutory prohibition beyond its narrow constitutional bounds, but only "to abolish the formalistic distinction between taxes *on* income and taxes *measured* by income." 470 U.S. at 593-94. Hence, the 1959 amendment did not exempt additional forms of income from state taxation; it only clarified that States were precluded from imposing any form of taxation, whether direct or indirect, on those narrow categories of income set forth in the statute. *See id.* at 594 (no indica-

tion in legislative history "that Congress understood the addition actually to broaden the scope of the exemption, as well as to clarify the forms of taxes to which the exemption applied").

The Nebraska Supreme Court's extension of tax-immune status to repurchase agreements, despite Section 3124's clear language limiting the tax exemption to federal obligations and interest on federal obligations, represents precisely the type of judicial broadening of intergovermental tax immunity that the Court has repeatedly warned against. As the Court admonished in *Smith*, Congress' "intent to immunize from state taxation only the interest-bearing obligations of the United States which are needed to secure credit to carry on the necessary functions of government[,] . . . . which is largely codified in § 3701, should not be expanded or modified in any degree by the judiciary." 323 U.S. at 119, *quoted in Rockford*, 482 U.S. at 191-92. *See also California State Bd. of Equalization v. Sierra Summit, Inc.*, 490 U.S. 844, 851-52 (1989) ("[W]e have stated that '[a] court must proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly expressed.' ") (citing *Rockford*, 482 U.S. at 191). *Cf. Smith*, 323 U.S. at 117 ("Tax exemptions being the exception rather than the rule, much clearer language evidencing an intent to immunize open account claims under Section 3701 is necessary under these circumstances.").

B. The Taxation Of Repurchase Agreement Income Does Not Interfere With The Borrowing Power Of The Federal Government Or The Investment Attractiveness Of Federal Obligations In Violation Of Section 3124 Or Principles Of Intergovernmental Tax Immunity

Despite the clearly limited language of Section 3124, respondent argues that this Court has read the provision in a manner that would nonetheless shield repo income from taxation. Specifically, respondent relies on this Court's statement in *Smith*, referencing "the long established Congressional intent to prevent taxes which diminish in the slightest degree the market value or investment attractiveness of obligations issued by the United States in an effort to secure necessary credit." 323 U.S. at 117. Respondent then contends that Nebraska's taxation of repo income falls within this prohibition because it would impair the federal government's borrowing capacity and the attractiveness of its obligations. This argument is unavailing for two reasons: there is no evidence to support it, and it is based on a misreading of this Court's precedents.

1. *There Is No Evidence That State Taxation Of Repurchase Income Impedes The Borrowing Power Of The Federal Government Or Reduces The Investment Attractiveness Of Federal Securities*

Both respondent and the Nebraska Supreme Court rely primarily on testimony of Peter D. Sternlight, Executive Vice President of the Federal Reserve Bank of New York (FRBNY), that was submitted in another case, in contending that Nebraska's taxation of repurchase income impedes the borrowing power of the federal government and makes federal securities less attractive. *See* Opp. 7-9 & App; J.A. 22-43. But Sternlight's affidavit, which was prepared in the context of a bankruptcy proceeding, totally fails to support respondent's contention or the Nebraska Supreme Court's conclusion.[4]

Most importantly, Sternlight's affidavit offers no opinion whatsoever as to the effect of state taxation on re-

[4] As the Nebraska Supreme Court explained, the testimony of Peter Sternlight upon which it relied was given in a deposition conducted in another case involving the same issue, *Page v. Department of Revenue, State of Florida*, No. CI 87-2586, which was litigated in the Circuit Court of the Ninth Judicial Circuit, Orange County, Florida. Pet. App. 7. That deposition, however, centered on an affidavit which Sternlight had prepared in connection with yet another proceeding, *Bevill*, 67 B.R. 557, a bankruptcy case. *See* J.A. 23-28 (Sternlight deposition); J.A. 39-43 (Sternlight affidavit).

purchase agreements. This is not surprising, since the affidavit was prepared in a case involving a bankruptcy question. The "hobbling of the repo market" warned of in ¶ 7 of the affidavit, J.A. 42, references not the effect of taxation, as respondent would have this Court believe, but uncertainty as to the effect of bankruptcy on repurchase agreements. This is clear not only from the context in which the affidavit was prepared, but also from the fact that Sternlight's testimony in a Congressional hearing involving proposed bankruptcy amendments tracks, almost verbatim, his statements in this portion of the affidavit. *Compare Bankruptcy Reform: Hearing Before the Subcomm. on Courts of the Senate Comm. on the Judiciary*, 98th Cong., 1st Sess. 314-15 (Statement of Peter D. Sternlight) (1983) [hereinafter Senate Hearing] *with* J.A. 42 ¶ 7.

In the Senate Hearing, Sternlight outlined the problems that could affect the repo market if the uncertainty surrounding bankruptcy treatment were not resolved:

> More generally, a hobbling of the repo market could have broad rate effects throughout the financial markets, diminishing efficiency in the allocation of resources. Market participants would turn to less liquid forms of investment or more costly sources of funds—in either case tending to produce higher rates in the economy at large. Greater volatility of rates as a consequence of a diminished repo market could also add to average rate levels.

Id. Sternlight then went on to testify in the Senate Hearing that these problems could best be resolved by "modify[ing] the Bankruptcy Code . . . ." *Id.* at 315.[5]

[5] *See also Bankruptcy Law and Repurchase Agreements: Hearing on H.R. 2852 and H.R. 3418 Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary*, 98th Cong., 2d Sess. 50-58 (Statement of Peter D. Sternlight) (1984) [hereinafter House Hearing]. Statutory amendments to the Bankruptcy Code have alleviated many of the liquidity concerns raised by Sternlight in his testimony in Congressional hearings. *See* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. Law No. 98-353, § 396(a), 1984 U.S.C.C.A.N. (98 Stat.) 333, 366 (codified at 11 U.S.C. § 559); Osenton, *The Need for a Uniform Classification*, 36 Am. U. L. Rev. at 684 ("By passing section 559, Congress restored the liquidity that repo investors and the economy need and expect.").

Sternlight's response to questions involving taxation further clarify that his testimony was not directed at the consequences of tax treatment. During his deposition in the *Page* case, he responded to a question about the federal tax treatment of repo income by disclaiming any "expert familiarity" in that area. J.A. 31. Similarly, in a letter submitted in connection with a Congressional hearing involving proposed bankruptcy amendments, he indicated that the amendments would have no effect on the characterization of repurchase agreements for tax purposes. *See* House Hearing at 106 (letter of Peter D. Sternlight to Hon. Peter W. Rodino, Jr.) ("While I would not want to claim expertise on the treatment of repos for tax purposes, it seems to me that the enactment of H.R. 2852 and 3418 should not affect the characterization of repos under the tax laws . . . .").

Nor does Sternlight's affidavit suggest that the characterization of repurchase agreements as loans for Section 3124 purposes would trigger untoward consequences; his discussion of the dangers of a "secured loan" characterization, *see* J.A. 41 ¶ 5, were made in a case where the characterization of repos for bankruptcy purposes was at issue. The characterization for tax purposes, which is based on the economic essence of a transaction, need not be binding in other settings where factors other than economic essence are important. Indeed, the Fed's own characterization of repos as sales and repurchases in the bankruptcy context is not viewed as controlling in other contexts, such as taxation. *See* House Hearing at 106-07 (letter of Peter D. Sternlight) ("while the Federal Reserve has gone on record as favoring purchase-and-sale characterization of repurchase agreements, that statement

is limited to a bankruptcy context and should not be taken as an endorsement of purchase-and-sale characterization for tax, accounting, or other purposes"); *see also* Stigum, *The Repo and Reverse Markets* at 325 (discussing contexts in which Fed "describes the repos it does as *credit* transactions that add to bank reserves").[6]

The Sternlight affidavit is not probative of the finding of the court below that a "state tax on [repo] income would diminish the market value and investment attractiveness of federal securities . . . [and] impose a burden on the federal government's regulation of the nation's money supply." Pet. App. A-13. It is therefore a wholly insufficient basis for extending intergovernmental tax immunity to the repurchase agreement income of private parties under the language of *Smith v. Davis*. The Court has flatly rejected the notion that a prohibited effect on the marketability or attractiveness of government obligations can be inferred from the mere withdrawal of a tax benefit, in the absence of supporting evidence. In *First National*

[6] The idea that repos might be characterized differently in the bankruptcy and taxation areas is easily explained. In the bankruptcy context, the parties' intent is an important part of the characterization determination, whereas in taxation, economic substance alone controls. *See Bevill*, 67 B.R. at 594 (distinguishing tax cases characterizing repos as collateralized loans in which courts had found that "the parties' intent underlying their contractual relations was not relevant to the legal characterization of the transaction for federal income tax purposes," from bankruptcy cases in which "the intent of the parties is a central consideration" and "[c]onsiderations relating to the economic substance of the transactions, while relevant to this determination, are certainly not controlling") (citations omitted). *See also Gilmore v. State Board of Administration of Florida*, 382 So. 2d 861, 863 (Fla. Dist. Ct. App. 1980) (characterization of repurchase agreement applicable in default context might not be appropriate in tax context). The exclusive focus on economic substance in the tax context is driven by the need to preclude tax avoidance by the taxpayers through creative formulation or labelling of their dealings. *See Bevill*, 67 B.R. at 594 (noting that the courts in tax cases "were concerned with the tax avoidance possibilities associated with the transactions and focused their attention solely on their economic substance").

Bank, for example, the Court found that there was no evidence indicating that the removal of a tax shelter would be enough to "prompt banks to forgo the advantages of federal obligations, such as their extreme liquidity and safety, and to invest their money elsewhere." 470 U.S. at 597.[7]

The same analysis applies here. Repurchase agreements are a uniquely attractive financial tool in a wide variety of investment contexts. *See, e.g.*, Osenton, *The Need for a Uniform Classification*, 36 Am. U. L. Rev. at 670-71 ("Retail repos give investors what they want most—liquidity, security, and high-yield.") (footnote omitted); Stigum, *The Repo and Reverse Markets* at 107-114 (describing unique attractiveness of repos for different types of investors). Indeed, many investors, including state and local governments, may be prohibited from engaging in other types of investments and may view repos as their most attractive alternative. *See* Stigum, *The Money Market* at 589; J.A. 42-43, ¶ 8 (Sternlight affidavit). The absence of attractive substitutes for repurchase agreements suggests that state tax treatment is unlikely to influence many investors. *Cf. First Nat'l Bank*, 470 U.S. at 597. In fact, many States have taxed repurchase agreements for years, *see* footnote to attached Motion, yet there is no indication that investors are turning to other alternatives as a result.

In the absence of any indication that state taxation of repo income will adversely affect the federal government's borrowing power, there is no basis for the immunization of private repurchase agreements from taxation. As the Court explained in *Graves*, "it is plain that there is no basis for implying a purpose of Congress to exempt the

[7] The Court also noted that allowing the sheltering of otherwise taxable income under the auspices of § 3701 could lead a State to alter its tax strategy to place heavier reliance on the types of taxes expressly exempted from § 3701's prohibition on taxation; this would make the net effect on investment attractiveness uncertain. *First Nat'l Bank*, 470 U.S. at 596-97.

federal government or its agencies from tax burdens which are unsubstantial or which courts are unable to discern." 306 U.S. at 480. And, as *Rockford* recently reaffirmed,

> [W]hen effort is made, as is the case here, to establish the unconstitutional character of a particular tax by claiming that its remote effect will be to impair the borrowing power of the government, courts in overturning statutes, long established and within the ordinary sphere of state legislation, ought to have something more substantial to act upon than mere conjecture. The injury ought to be obvious and appreciable.

482 U.S. at 190 n.10 (quoting *Plummer v. Coler*, 178 U.S. 115, 137-38 (1900)). There has been no showing in this case of an obvious and appreciable impairment of the power of the federal government.

2. *An Attenuated Impact On Borrowing Power Or Investment Attractiveness Would Be Insufficient To Confer Tax Immunity On Repo Income Under Section 3124 Or The Constitution*

Contrary to the Nebraska Supreme Court's holding and respondent's assertions, principles of intergovernmental tax immunity do not require the automatic invalidation of any state tax that might have even the slightest and most attenuated impact on the federal government's borrowing power or on the investment attractiveness of federal obligations. Hence, even if there were some slight marginal impact on the investment attractiveness of federal obligations flowing from Nebraska's taxation of repurchase agreement income, this would not be determinative as a matter of constitutional or statutory law. Respondent's contentions to the contrary are based on a misreading of this Court's precedents.

As a preliminary matter, it is quite significant that the Court's statement in *Smith v. Davis* regarding Congressional intent to prohibit taxes that would "diminish in the

slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit," 323 U.S. at 117, was made not in the context of forbidding taxes with an indirect or attenuated impact on government obligations, but in the context of determining Congressional intent as to the *types* of government obligations exempted from taxation. The Court's words can most fairly be read in this context as emphasizing that Congress sought to protect the value of certain types of obligations (*i.e.*, those issued by the United States in an effort to secure necessary credit) from being eroded through taxation, and that it had therefore shielded such obligations (and *only* such obligations) from taxation.

This reading is consistent with the language Congress used to define the boundaries of the tax exemption, which evidences no intent to encompass all taxation that is indirectly linked to or that might affect, in even the most highly attenuated fashion, a government obligation. Given the Court's insistence—in the very same paragraph of the *Smith* decision—on clear language to evidence Congress' intent to create a tax exemption, and its holding in *Smith* that the challenged state tax did not violate either constitutional or statutory principles of intergovernmental tax immunity, it is wholly implausible that the Court intended for its words to signal the vast and unprecedented expansion of tax immunity attributed to them by respondent and the court below. *See* 323 U.S. at 117. Indeed, it is impossible to square either the Court's holding or its closing admonition in the *Smith* case with such an interpretation:

> All of these related statutes are a clear indication of an intent to immunize from state taxation *only* the interest-bearing obligations of the United States which are needed to secure credit to carry on the necessary functions of government. That intent, which is largely codified in Section 3701, should not be expanded or modified in any degree by the judiciary.

Id. at 119 (emphasis added), *quoted in Rockford*, 482 U.S. at 191-92.

The Court's holdings, in cases both prior and subsequent to *Smith*, further clarify that the fact that a tax might have some attenuated impact on the value or attractiveness of federal obligations does not render it impermissible under statutory or constitutional principles of intergovernmental tax immunity. *See, e.g., Rockford*, 482 U.S. at 190 (any possible effect that taxation of Ginnie Maes might have on borrowing ability of the United States was "far too attenuated to support constitutional immunity"); *Willcuts v. Bunn*, 282 U.S. 216, 225 (1931) (power to tax should not be needlessly crippled "where no direct burden is laid upon the governmental instrumentality, and there is only a remote, if any, influence upon the exercise of the functions of government").[8]

Moreover, the Court has emphasized that "[t]he tax exemption required by the Constitution and § 3701 is not a tax shelter." *First Nat'l Bank*, 470 U.S. at 597. Thus, its statement in *Smith v. Davis* that every form of taxation is prohibited which would "diminish in the slightest degree the market value or the investment attractiveness of obligations issued by the United States," must be read as a prohibition only on affirmative tax erosion of the

[8] *Cf. United States v. New Mexico*, 455 U.S. at 734 (Tax immunity "may not be conferred simply because the tax has an effect on the United States."), *quoted in Rockford*, 482 U.S. at 191 n.11; *United States v. California*, 113 S.Ct. 1784, 1788-89 (1993) (Although the federal government "is absolutely immune from direct taxes, it is not immune from taxes merely because they have an 'effect' on it, or 'even because the Federal Government shoulders the entire economic burden of the levy' . . . . Tax immunity is 'appropriate in only one circumstance: when the levy falls on the United States itself, or on an agency or instrumentality so closely connected to the Government that the two cannot realistically be viewed as separate entities.' ") (citations omitted); *James v. Dravo Contracting Co.*, 302 U.S. 134, 160 (1937) (fact that a tax imposed on a government contractor may increase the cost to the government does not render it invalid).

value of federal securities and the interest that they earn. In other words, the baseline or starting point which may not be diminished by taxation (and which Nebraska has not sought to tax) is the federal obligation and the interest that it earns. Clearly, a State does not violate principles of intergovernmental tax immunity because it fails to provide *added* tax benefits to holders of federal securities or those with whom they deal, simply because this could be said to "diminish" the value or attractiveness of the federal security compared to what it might be if those added tax benefits were granted.[9]

Such a failure to bestow extra tax advantages is obviously not the type of prohibited diminishment that the Court spoke of in *Smith*. Yet respondent's contention that taxation of repo income would diminish the value or attractiveness of federal obligations, even if true, suffers from this same fallacy. Repo income does not represent a federal obligation or interest earned thereon, and hence is not part of the baseline protected by constitutional and statutory principles of intergovernmental tax immunity. States are not required to maximize the attractiveness of federal obligations by granting special tax benefits to all who come into contact with them; they are only required to abide by the constitutional and statutory rule that taxation not erode the value of the federal obligations themselves or the interest that the obligations generate and thereby constitute "a direct interference with the functions of government itself." *New Mexico*, 455 U.S. at 736 (citation omitted).

As the Court explained in *Graves*, in the context of taxes imposed on government employees, the

[9] For example, it is obvious that exempting holders of federal obligations from state income tax on any of their earnings (whether related to the federal obligations or not) would make holding a federal obligation more attractive. Consequently, failing to provide those benefits could be said to "diminish" the attractiveness of the obligations compared to the attractiveness they would enjoy if those benefits were provided.

> purpose of [intergovernmental tax] immunity was not to confer benefits on the employees by relieving them from contributing their share of the financial support of the other government, whose benefits they enjoy, or to give an advantage to that government by enabling it to engage employees at salaries lower than those paid for like services by other employers, public or private, but to prevent undue interference with the one government by imposing on it the tax burdens of the other.

306 U.S. at 483 (footnote omitted) (citing *Helvering v. Gerhardt*, 304 U.S. 405 (1938)). And in *First National Bank*, the Court reaffirmed this "fair share" idea by holding that States may, through their tax laws, "charg[e] tax-exempt obligations and interest their fair share of related expenses or burdens." 470 U.S. at 593 (footnote omitted).[10]

Accordingly, taxpayers' attempts to shelter income by acquiring tax exempt securities as liabilities have been rebuffed by the Court. In *First National Bank*, the Court upheld a Georgia tax based on banks' net worth which permitted only the deduction of the pro rata share of tax-exempt securities that represented assets. If a full tax exemption were allowed for all federal securities, the Court found, banks could shelter otherwise taxable assets and avoid their fair share of the tax burden by acquiring federal securities as liabilities. *See id.* at 596-97.

The *First National Bank* decision thus reaffirmed the "fair share" theme that had appeared in prior decisions involving efforts to obtain extra tax benefits through the borrowing of money to purchase tax-exempt securities.

[10] *Cf. United States v. Atlas Life Insurance Co.*, 381 U.S. 233, 251 (1965) ("The doctrine of intergovernmental immunity does not require such a [tax] benefit to be conferred on the ownership of municipal bonds."); *Helvering v. Gerhardt*, 304 U.S. at 421 (collecting cases in which "[t]he fact that the expenses of the state government might be lessened if all those who deal with it were tax exempt was not thought to be an adequate basis for tax immunity").

See Atlas Life, 381 U.S. at 247; *Denman v. Slayton*, 282 U.S. 514 (1931). The *First National Bank* Court also clarified that it had adopted the dissenting view of Justice Stone in *Missouri v. Gehner*, 281 U.S. 313 (1930). *See* 470 U.S. at 591. In *Gehner*, Justice Stone stated that "[t]he immunity of government bonds from taxation does not carry with it immunity from liability for debts." 281 U.S. at 323 (Stone, J., joined by Holmes and Brandeis, JJ., dissenting) (citation omitted).

This case involves a similar effort to reap a second tax advantage from government securities, and thereby to avoid paying a fair share of taxes on income from a private credit arrangement. *Cf. Union Planters Nat'l Bank of Memphis v. United States*, 426 F.2d 115, 116 (6th Cir.) (if income on repos involving municipal bonds were not taxable, taxpayers "would be able to enjoy the benefit of the double tax advantage which Congress intended to prevent"), *cert. denied*, 400 U.S. 827 (1970). Here, not only does the original owner of the government securities continue to receive a tax exemption for interest paid on the government instrument during the term of the repurchase agreement, but the respondent also seeks to claim a tax exemption for the interest he receives from the holder of the government securities for the use of his money during the repurchase term.

In sum, the notion that intergovernmental tax immunity can be used to obtain double tax benefits by incurring liabilities to obtain tax-exempt securities has been soundly rejected. *See, e.g., First Nat'l Bank*, 470 U.S. at 596. In legal and economic effect, it makes no difference that in this case the interest Nebraska seeks to tax is paid not on a loan taken out to *buy* government securities, but on a loan taken out to increase cash flow *after buying* tax exempt government securities (for which those securities are used as collateral). *See Union Planters*, 426 F.2d at 116 (tax exemption for repo income would circumvent Congress' purpose of preventing double tax benefit in IRC § 265(2)).

C. Principles Of Intergovernmental Tax Immunity Require That The Federal Tax Treatment Of Repurchase Income Involving Municipal Bonds Be Analyzed In The Same Manner As State Tax Treatment Of Repurchase Income Involving Federal Obligations

Constitutional principles of intergovernmental tax immunity work not only to protect the instrumentalities of the federal government from state and local taxation, but also to protect state and local government instrumentalities from federal taxation. *See, e.g., Educational Films Corp. v. Ward*, 282 U.S. 379, 392 (1931) ("the purpose [of intergovernmental tax immunity] is the preservation to each government, within its own sphere, of the freedom to carry on those affairs committed to it by the Constitution, without undue interference by the other") (collecting cases).

Although the scope of the intergovernmental tax immunity afforded state and local governments is not always identical to that afforded the federal government, *see, e.g., McCulloch*, 17 U.S. (4 Wheat.) at 435-36, the Court has noted that "federal and state tax immunity cases have always shared the identical methodology for determining whether a tax is 'on' a government, and . . . this identity has persisted even though the methodology for both federal and state immunities has changed as intergovernmental tax immunity shifted into the modern era." *South Carolina v. Baker*, 485 U.S. at 518 n.11. *See also Plummer*, 178 U.S. at 117 ("[t]he reasoning upon which these two lines of decision proceed is the same").

Therefore, the question of whether the income on a repurchase agreement involving government securities is too attenuated from the exempt security itself to warrant tax immunity is a question which should be answered in exactly the same manner for the federal taxation of repurchase income involving municipal bonds, as for the state taxation of repurchase income involving federal securities. *Cf. First Nat'l Bank*, 470 U.S. at 591 (applying

doctrine set forth in a case involving the federal taxation of municipal bonds to question involving state taxation of federal obligations) (citing *Denman v. Slayton*, 282 U.S. 514 (1931)); *Dravo Contracting*, 302 U.S. at 157 ("While the Metcalf Case was one of a federal tax, the reasoning and the practical criterion it adopts are clearly applicable to the case of a state tax upon earnings under a contract with the federal government.").

Federal appellate courts considering the question of the federal taxation of income from repurchase agreements involving municipal bonds have consistently held that such income is taxable, despite the exemption granted to municipal bond interest in the Internal Revenue Code. *See, e.g., Union Planters*, 426 F.2d at 118; *American Nat'l Bank of Austin v. United States*, 421 F.2d 442 (5th Cir.), *cert. denied*, 400 U.S. 819 (1970); Stigum, *The Repo and Reverse Markets* at 334 & n.2 (collecting cases). In so holding, these federal courts have used reasoning that closely parallels that used by state courts holding that repurchase income is taxable. *See, e.g., American Nat'l Bank of Austin*, 421 F.2d at 452 ("In short, taxpayer was in effect a lender secured by collateral in its possession. Under these circumstances, we would be blinding ourselves to reality if we did not see quite clearly that taxpayer's role here was that of a lending institution . . . ."); *Union Planters*, 426 F.2d at 118 (repos "will be regarded as secured loans for federal income tax purposes"). *See also* Stigum, *The Repo and Reverse Markets* at 334 ("In the cases that the [federal] government won, the courts treated the [municipal bond] repos in question as collateralized loans rather than as purchases and sales of securities. The focus of the courts in those cases was on the *economic substance* of the repo transactions.").

If the Court prohibits Nebraska from taxing respondent's repo income, it will inevitably call into question the federal government's ability to tax repo income involving municipal bonds, upheld in the foregoing cases. Equality

of treatment in the two instances is required as a matter of logic and law, since the same reasoning concerning whether the repurchase income is closely enough linked to the underlying instrument to take on its tax exempt status is applicable in challenges to the taxing authority of either sovereign.

CONCLUSION

The judgment of the Nebraska Supreme Court should be reversed.

Respectfully submitted,

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May 3, 1994

MOTION
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(5)

No. 93-823

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE,

Petitioner,

—v.—

JOHN LOEWENSTEIN,

Respondent.

ON WRIT OF CERTIORARI TO THE SUPREME COURT OF NEBRASKA

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF *AMICUS CURIAE* OF THE FEDERAL RESERVE BANK OF NEW YORK

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OF NEBRASKA

Motion for Leave to File Brief *Amicus Curiae* and Brief *Amicus Curiae* of the Federal Reserve Bank of New York.

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The Federal Reserve Bank of New York ("New York Fed") respectfully moves for leave to file the attached *amicus curiae* brief. The consent of the attorney for the petitioner has been obtained. The consent of the attorney for the respondent was requested but refused.

The New York Fed has two interests in this case. The Nebraska Supreme Court relied heavily on inferences drawn from testimony given by Peter D. Sternlight, a retired executive vice president of the New York Fed. The New York Fed does not believe that the testimony supports these inferences, and wishes to express an official position on repurchase agreements and their significance to the government securities market. Second, the New York Fed is concerned about the possibility of inadvertent dicta in this case, that could adversely affect the depth and liquidity of the government securities market.

These interests are distinct from those of the parties, who are principally concerned with the taxability of income arising from repurchase transactions. Furthermore, the New York Fed believes that its considerable expertise in repurchase transactions and their role in the government securities market may be of assistance to the Court.

Respectfully submitted,

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Statement of Interest

The Federal Reserve Bank of New York ("New York Fed") submits this *amicus curiae* brief to assist the Court in understanding repurchase agreements ("repos" or "repo transactions"), to explain the importance of repos in the money market, and to avoid possible destructive consequences of a decision stating that repos are secured loans. An improper characterization of the repo transaction may unintentionally disrupt their intended operation under state commercial law and cause many governmental and quasi-governmental organizations to withdraw from this important sector of the nation's money market. The result would be a far less liquid market, to the detriment of those who remain eligible to participate, and with adverse effects on fiscal policy.

The New York Fed is also concerned about being misinterpreted. The Nebraska Supreme Court relied heavily on inferences drawn from testimony given by Peter D. Sternlight, a now-retired executive vice president of the New York Fed.[1] Although we endorse Mr. Sternlight's testimony, we believe that some of the inferences drawn from this testimony by the Nebraska Supreme Court are unwarranted.

Summary of Argument

This is a state tax case arising under 31 U.S.C. § 3124. Most of the courts that have considered the state taxability of repo income have resolved the issue by engaging in a characterization exercise: are repos "secured loans" or "sales and repurchases"? This characterization is outcome determinative: if secured loans, the income produced is subject to state taxation.

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[1] We understand that this deposition testimony, and an attached affidavit, are in the Joint Appendix. We shall be citing the affidavit in this brief without the benefit of the Joint Appendix pagination, which is prepared by the parties. We therefore attach the affidavit as an appendix to this brief.

The New York Fed is concerned with the possible effects of this characterization exercise. If repos are broadly characterized by this Court as secured loans, the market in government securities might lose much of its depth and liquidity.

Fortunately, this case may be decided without characterizing the nature of a repo. We urge this Court to decide this case consistently with its prior construction of 31 U.S.C. § 3124, which does not involve characterization of the underlying transaction, but rather explores the economic impact of a state tax on the underlying government securities.

The Nebraska Supreme Court applied the correct legal standard, and tried to explore the economic impact of the state tax. But its economic analysis hinged on the meaning of Mr. Sternlight's testimony. The New York Fed can find nothing in Mr. Sternlight's testimony that supports the meaning given it by the Nebraska Supreme Court. A more appropriate analysis of economic impact may well be consistent with the Nebraska Supreme Court's outcome, or it may not. But Mr. Sternlight's testimony, although correct in all respects, is not relevant to economic impact of state taxation and should not be part of this Court's analysis.

The New York Fed has a strong interest in this Court's analysis of this case but has no interest in the outcome. We, therefore, depart from customary practice and file this *amicus* brief on behalf of neither party. The New York Fed's interest is confined to clarifying the meaning of Mr. Sternlight's testimony and ensuring that this Court avoid an unnecessary or overly broad characterization of the repo transaction.

Argument

We begin with a description of the repo transaction and the role of this transaction in the government securities market.

Repos are generally structured as a contract for the sale (or purchase) of a security, subject to a simultaneously created forward agreement for the repurchase (or resale) of the same

or a similar security at an agreed date.[2] *See SEC v. Drysdale Secur. Corp.*, 785 F.2d 38, 41 (2d Cir.), *cert. denied sub nom. Essner v. SEC*, 476 U.S. 1171 (1986); Affidavit of Peter D. Sternlight, April 11, 1986, at ¶¶ 1-3 (hereinafter "Sternlight Affidavit"). Repos are over-the-counter transactions, sometimes brokered and sometimes entered into directly between parties. The expression "repurchase agreement" actually encompasses two separate market transactions—the repo and the reverse repo. They are in essence the same transaction viewed from different perspectives. A repo is a transaction in which securities are sold subject to an agreement to repurchase; a reverse repo (or "reverse") is to a transaction in which securities are bought subject to an agreement to resell.

We fully agree with the portion of Judge Debevoise's anaysis of the repo excerpted below. *In re Bevill, Bresler & Schulman Asset Management Corp.*, 67 Bankr. 557, 566-67 (D.N.J. 1986) ("*BBS*"). Judge Debevoise wrote:

> A standard repo consists of a two-part transaction. The first part consists of the transfer of specified securities by one party, the seller, to another party, the buyer, in exchange for cash. The second part consists of the contemporaneous agreement by the seller to repurchase the securities at the original price, plus an agreed upon amount of interest, on a specified future date. . . . A standard reverse repo consists of the same two-part transaction viewed from the perspective of the buyer. Thus, when one sells a security and agrees to buy it back, he is engaged in a repo transaction. When the same party buys a security and agrees to sell it back, he is engaged in a reverse repo transaction.

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[2] This case concerns repos in government securities, but repos can be done with any security or other items of value such as bankers' acceptances or even precious metals.

See also Bevill, Bresler & Schulman Asset Management Corp. v. Spencer Sav. & Loan Ass'n, 878 F.2d 742 (3d Cir. 1989) ("*BBS II*").

The repo transaction is extremely liquid because it can afford the holder of the securities the rights of ownership. The holder of the securities:

> take[s] title to the securities received and can trade, sell or pledge them. The repo merely imposes a contractual obligation to deliver identical securities on the settlement date set by the repo contract . . . . the secured lender is free to deal the "collateral."

Drysdale, 785 F.2d at 41. Because a repo is *not* generally structured as a collateralized loan, the holder of the repo securities can sell the securities at will, subject only to the legal obligation to redeliver securities of the same description on the forward settlement date.[3]

This liquidity feature has made repos the principal method of financing positions in government securities. United States Department of the Treasury, Securities and Exchange Commission & Board of Governors of the Federal Reserve System, *Joint Report on the Government Securities Market* A-11 (1992) ("Joint Report"). In effect, repos allow a dealer to use its constantly-changing inventory of government securities to finance its day-to-day operations, without losing any of the dynamism of the inventory. In the course of a single day, a dealer can easily convert a government security to cash through a repo trade, and position the cash in another government security through a reverse repo transaction. This can occur any number of times, permitting dealers to turn over their inventory in response to market conditions, providing the means for creating hedges and arbitrages among various

[3] The New York Fed notes that this description applies to repos that are structured in conformity with general market practice and expectations. Parties can and do structure repos which closely resemble secured loans. These atypical transactions strengthen the New York Fed's main point—characterization of repos is a dangerous process.

issues and thereby increasing the liquidity of the market. Sternlight Affidavit, ¶ 7.

Furthermore, reverse repo transactions serve as low-cost and flexible means of borrowing securities. Borrowed securities are critical in the government securities market, permitting short-selling and ensuring that market participants will be able to complete the securities end of a transaction, avoiding a "fail". If, near the end of day, a market participant finds itself short securities that it is contractually obligated to deliver, it usually obtains these securities on the reverse repo market. *Joint Report*, at A-12.

Repos add not only liquidity to the government securities market, but participants, as well. Corporations, municipalities (including entities such as school districts), financial institutions and pension funds participate in the government securities markets through repo transactions, as well as dealers. *Id.*; Sternlight Affidavit, ¶ 8. Many of these participants, particularly the municipalities, are not empowered to make collateralized loans, but still seek a way of earning interest in a short-term transaction with little or no risk of loss. Accordingly, they may participate in the government securities market through repo transactions only if repo transactions are not characterized as collateralized loans. *Id.*

Statistics reveal the economic significance of repo transactions. A recent figure placed outstanding repos and reverses at $1.5 *trillion*. 80 *Fed. Res. Bull.* A32 (April, 1994). Over $700 billion of this market turns over every day. *Id.*[4] As observed by the court in *BBS II*, 878 F.2d at 742, if the volume of repo transactions were placed next to the volume of transactions in the stock market, the size of the former would easily dwarf the size of the latter.

[4] Both the $1.5 and $0.7 trillion figures were obtained from line items 25-28 of Table 1.43, for the week ending January 19, 1994. The smaller figure is for "overnight and continuing" repo which, in effect, turns over every day, as does some of the term repo.

I. The Depth and Liquidity of the Government Securities Market Would be Impaired by Characterizing Repos as Secured Loans.

Repos are crucial to both the secondary and primary markets in government securities. Repos finance new government debt: the dealers who underwrite new Treasury issues rely heavily on repos pending ultimate resale to investors. Sternlight Affidavit, ¶ 6. As discussed above, repos facilitate a very deep and liquid secondary market for government securities. By promoting liquidity and adding depth in both the primary and secondary markets, repos help lower the interest rate on Treasury obligations, saving funding costs for the Government.

The repo market is supported in significant part by entities with charter or regulatory restrictions that prevent them from making secured loans. These entities lack legal authority to make secured loans but may participate in repo transactions so long as these transactions may be fairly characterized as securities purchases and sales.[5] Any general characterization of repos as secured loans could, therefore, jeopardize the continued participation of these investors in the repo market. This would deprive the market of much of its depth and, therefore, much of its liquidity.

This depth and liquidity not only serve to lower the price of government securities; they are crucial to the monetary policy operations conducted by the New York Fed. *See Federal Open Market Committee v. Merrill*, 443 U.S. 340, 343 (1979). Indeed, repo transactions are the primary tool of the New York Fed in conducting these monetary policy operations.

[5] *See, e.g.*, N.Y. Const. Art. VII § 8 (McKinney 1993) (prohibition on state lending money to private parties); N.Y. Const. Art. VIII § 1 (McKinney 1993) (prohibition on municipalities doing same); N.J.S.A. Const. Art. 8 § 2 ¶ 1 (1993) (similar). *Cf. In re Lion Capital Group*, 49 Bankr. 163, 181-83 (Bankr. S.D.N.Y. 1985) (because of municipal charter restrictions, repo clearing bank should have known that accounts were meant to be segregated).

Sternlight Affidavit, ¶ 4; Ann-Marie Meulendyke, *U.S. Monetary Policy and Financial Markets* 45, 155-56, 170-72 (1989). Repos have been important throughout the postwar era. *See, e.g., Thirty-Eighth Annual Report of the Board of Governors of the Federal Reserve System, 1951* at 107-08. Once again, statistics reflect this best. Table 1.17 of the April edition of this year's *Federal Reserve Bulletin* describes the Federal Reserve Open Market Transactions as of the end of 1993. 80 *Fed. Res. Bull.* at A10. Line 27 gives an approximate notion of the volume of the New York Fed's trading desk's repo transactions involving Treasury securities—half a trillion dollars for the year 1993. In contrast, the trading desk purchased outright only a gross 37 billion dollars of Treasury securities, as shown by line 22. The rough import of these numbers is clear—around 90 per cent of the New York Fed's open market transactions involve repos.[6]

II. This Case May be Decided Without Characterizing Repos.

This case may be decided without characterizing repos. Admittedly, most lower courts considering the amenability of repo income to state taxation pursuant to 31 U.S.C. § 3124 have performed the characterization exercise and have characterized repo transactions as, in essence, collateralized loans. *See, e.g., Andras v. Dep't of Revenue*, 154 Ill. App. 3d 37, 106 Ill. Dec. 732, 506 N.E.2d 439, 443-44 (2d Dist. 1987), *cert. denied*, 485 U.S. 960 (1988).[7]

[6] In fact, the power of the New York Fed to participate in the repo market derives in large part from the purchase-and-sale characteristics of repo transactions. 12 U.S.C. § 355(2); Sternlight Affidavit, ¶¶ 3-5.

[7] *See also, e.g., Department of Revenue v. Page*, 541 So.2d 1270 (Fla. App. D5 1989) (employing *Andras* factors); *Massman Constr. Co. v. Director of Revenue*, 765 S.W.2d 592 (Mo. 1989) (employing a different test); *Citizen's Nat'l Bank of Waco v. United States*, 551 F.2d 832, 838 (Ct. Cl. 1977) (federal tax case). *See infra* note 10 (more cases).

Interestingly, one of these courts later recanted, calling its characterization a "dictum" when it realized that the characterization could have

Courts have done this because they tend to reason by analogy. Generally, state tax statutes do not cover repo transactions, but they do cover interest realized on loans. A court asked to decide whether the income from a repo is subject to state taxation will naturally analogize the repo to that which the law clearly covers—secured loans, for example.[8] This may be a reasonable treatment of state tax law but it is not a reasonable analysis under 31 U.S.C. § 3124.

The case law interpreting 31 U.S.C. § 3124 does not work by characterization. A state tax violates this section (and the Constitution) if it "imposes an intolerable burden on Federal obligations by threatening to diminish their value." *Am. Bank & Trust Co. v. Dallas Cty.*, 463 U.S. 855, 870 (1983); *see also First Nat'l Bank of Atlanta v. Bartow Cty. Board*, 470 U.S. 583, 596 (1985). "A state tax that imposes a greater burden on holders of federal property than on holders of similar state property impermissibly discriminates against federal obligations." *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983). It is the existence (and perhaps magnitude) of this threat that is at issue here; not the proper characterization of repos.

III. The Nebraska Supreme Court Misapplied the Sternlight Affidavit.

Unlike many other courts, the Nebraska Supreme Court kept the preemption issue separate from its analysis of state

unfortunate state law consequences. *Compare Hammond Lead Products, Inc. v. State Tax Com'rs*, 549 N.E.2d 424, 429 (Ind. Tax. 1990), *aff'd*, 575 N.E.2d 998 (Ind. 1991) ("in effect . . . collateralized loans") with *Indiana Dep't of State Revenue v. Hardware Wholesalers*, 622 N.E.2d 930, 932 (Ind. 1993) (characterization "was dictum because the court was not required to classify such transactions, but only to determine whether such transactions really transferred ownership of the underlying securities.")

[8] This Court used a similar analysis to conclude that securities lending transactions are actually purchases and sales for purposes of a Federal transfer tax. *Provost v. United States*, 269 U.S. 443, 455-57 (1926).

tax law. *Loewenstein v. Dep't of Revenue*, 244 Neb. 82, 504 N.W.2d 800 (1993), *cert. granted*, ___ U.S. ___, 114 S.Ct. 1215, 127 L.Ed.2d 562, 62 U.S.L.W. 3588 (1994). The Nebraska Supreme Court stated:

> [T]he state tax clearly imposes a burden on the market for federal securities. A review of the expert testimony of Sternlight makes it clear that a state tax on such income would diminish the market value and the investment attractiveness of federal securities, that the tax would impose a burden on the federal government's regulation of the nation's money supply, and that such tax would increase the costs to the federal government in financing the national debt.

Id. at 90, *id.* at 805. The *Loewenstein* court relied upon Mr. Sternlight's statements but appeared to have drawn some inferences from them that Mr. Sternlight did not intend and are unwarranted.

The context of Mr. Sternlight's statements is important. Mr. Sternlight's deposition was taken in connection with *Page*, 541 So.2d at 1270, a case raising issues similar to *Loewenstein*. This deposition was based on the Sternlight Affidavit and did nothing but ratify the Affidavit. The Sternlight Affidavit was filed by the New York Fed in 1986 as *amicus curiae* in the *BBS* case, which had nothing to do with state taxation of repo income.[9]

The Sternlight Affidavit does not mention taxes. Nor did Mr. Sternlight testify about taxes in his deposition. Mr. Sternlight addressed the charter restrictions alluded to above, and various commercial law characterizations of repo transactions. Sternlight Affidavit, at ¶¶ 3-8. Mr. Sternlight opined that certain improper characterizations of repos could be destructive. But Mr. Sternlight did not opine on the economic effect of state taxation of repo transaction income on the underlying

[9] The *BBS* court devised an appropriate treatment of repos in the context of commercial law and the Bankruptcy Code.

government securities, which is the ultimate issue to be addressed here.

IV. The Supreme Court Should Perform a Direct Section 3124 Analysis without Using the Sternlight Affidavit, and Without Characterizing Repos.

As argued above, characterization of repos is irrelevant to the 31 U.S.C. § 3124 inquiry. This Court must decide whether the tax is preempted because of its economic effect on the underlying governmental securities. In other words, it must decide whether a state tax on repo income has an effect on the price of government securities that rises to the level of a Section 3124 encroachment.

Not only is characterization of repos legally unnecessary, it is unwise. As Judge Debevoise found in the *BBS* case:

> The foregoing discussion leads to one inescapable conclusion: repos and reverse repos are hybrid transactions which do not fit neatly into either a secured loan or purchase and sale classification. There is no question that repo and reverse repo transactions have functional attributes which resemble collateralized loans. The initial taking of margin (the "haircut"), the right of substitution, and the "mark-to-market" provisions are undeniably secured loan characteristics not commonly found in purchase and sale transactions. . . . On the other hand, the repo buyer's unrestricted right to trade the securities during the term of the agreement represents an incident of ownership which does not pass to a secured lender in a collateralized loan transaction. . . . Clearly, any attempt to determine whether a repo or reverse repo transaction is more like a secured loan than a purchase and sale by weighing economic factors on a finely tuned balance scale would be an essentially formalistic and ultimately unproductive enterprise.

BBS, at 596-97.

The New York Fed recognizes that, despite Judge Debevoise's warning, many courts have "functionally" characterized repos in a variety of settings.[10] Except for one poor decision which ultimately led to enactment of 11 U.S.C. § 559,[11] the market so far has adjusted to these characterizations. The most important consideration is that a "functional treatment" of repos be consistent with market practice and expectations. Athough unwise and risky, characterization can be tolerated if the opinion is correct on the facts and carefully limited as to possible consequences.

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[10] Taxation: *See supra* note 7; *Everett v. Dep't of Revenue and Finance*, 470 N.W.2d 13 (Iowa 1991); *Comptroller v. First United Bank*, 320 Md. 352, 578 A.2d 192 (1990); *Borg v. Dep't of Revenue*, 308 Or. 34, 774 P.2d 1099 (1989); *Capital Preservation Fund, Inc. v. Dep't of Revenue*, 145 Wis.2d 841, 429 N.W.2d 551 (Wis. App. 1988); *In re Sawyer Estate*, 149 Vt. 541, 546 A.2d 784 (1987).

Insolvency law: *In re Mt. Pleasant Bank & Trust Co.*, 426 N.W.2d 126 (Iowa, 1988) (calling repos, through implicit functional analysis, security interests and discussing their perfection).

Securities law: *Drysdale*, 785 F.2d at 38.

Insurance policy coverage: *First Fed. Sav. & Loan Ass'n of Toledo v. Fid. & Deposit Co. of Maryland*, 895 F.2d 254 (6th Cir. 1990) (meaning of repos in bankers' blanket bond); *RTC v. Aetna Cas. & Sur. Co.*, 831 F.Supp. 610, 620 (N.D. Ill. 1993) (same).

[11] The bankruptcy court in charge of the Lombard-Wall securities firm insolvency made a preliminary bench ruling that repo transactions were collateralized loans for the purposes of the automatic stay provisions of the Bankruptcy Code. This bench ruling, never published, created tremendous market uncertainty, leading to ultimate enactment of Section 559 of the Code. These events are described in *BBS II*, 878 F.2d at 747-48.

Conclusion

For all the foregoing reasons, *amicus curiae* Federal Reserve Bank of New York urges this Court to decide this case on grounds that do not involve characterizing repo transactions. Better yet would be an explicit dictum recognizing Judge Debevoise's point that repos are *sui generis* and do not take well to characterization. If this Court must characterize repo transactions, the New York Fed urges this Court to limit its opinion to tax cases only.

Respectfully submitted,

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APPENDIX

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

(Hon. Dickinson R. Debevoise)
Civ. No. 85-1728
Chapter 11

In the Matter of:
BEVILL, BRESLER & SCHULMAN ASSET MANAGEMENT CORPORATION,
Debtor.

Adversary Proceeding
No. 85-2103

SAUL S. COHEN, TRUSTEE OF BEVILL, BRESLER & SCHULMAN ASSET MANAGEMENT CORPORATION,
Plaintiff,

vs.

ARMY MORAL SUPPORT FUND, et al.,
Defendants.

Civ. No. 85-2224

In re:
BEVILL, BRESLER & SCHULMAN, INC.,
Debtor.

Adversary Proceeding
No. 85-5274

RICHARD W. HILL, TRUSTEE FOR THE LIQUIDATION OF BEVILL, BRESLER & SCHULMAN, INC.,

Plaintiff,

vs.

FIDELITY NEW YORK, F.A., et al,

Defendants.

STATE OF NEW YORK)
) ss:
COUNTY OF NEW YORK)

AFFIDAVIT OF PETER D. STERNLIGHT

1. I am Executive Vice President of the Federal Reserve Bank of New York ("FRBNY") with responsibility for the Open Market Operations Function.

2. I have had experience at the FRBNY's open market trading desk since the 1960's and for the past six years I have been Manager of the System Open Market Account ("SOMA"). In that capacity, I have responsibility for a variety of types of transactions undertaken by the FRBNY open market desk for the account of SOMA. The object of those transactions is to adjust the level of bank reserves in order to achieve the Federal Open Market Committee's monetary policy goals. FRBNY also carries out transactions in the market on behalf of foreign central banks to aid them in their dollar investments.

3. Repurchase agreements involving United States Treasury issues and certain other agency issues are essential to the operations of the open market desk for reserve adjustments. In addition, the liquidity and flexibility provided by repurchase agreements are essential to the efficient functioning of the government securities markets. Repurchase agreements are unique vehicles for short-term, high-volume financing. As used in the market today, repurchase agreements are viewed generally as contracts for the sale of securities and their resale back to the original seller at a future date. An essential feature of this arrangement is that securities delivered under a repurchase agreement are freely transferable and unencumbered by restriction from previous transfers.

4. During 1985, the FRBNY conducted SOMA transactions in the market in the aggregate amount of $212 billion. Of these, 74 percent were repurchase transactions, and 17 percent were reverse repurchase transactions (known to FRBNY as matched sale-purchase agreements). Thus, only 9 percent of the 1985 SOMA market transactions conducted by the FRBNY were conducted without the use of repurchase or reverse repurchase agreements. Also during 1985, the FRBNY conducted $188 billion worth of transactions in the market on behalf of approximately 150 foreign central banks and other foreign official institutions. Of these, some 62 percent were repurchase transactions. Federal Reserve operations in the market on a single day through repos or reverse repos often come to $3-4 billion and have reached as high as 7.9 billion.

5. The FRBNY repurchase transactions are, by statute, structured and conducted as contracts for purchase-and-sale. The high volume of Federal Reserve open market operations requires the broadest possible repurchase market for government securities. It is doubtful that the FRBNY would have access to a market for repurchase agreements characterized as secured loans. Such a result could impair the FRBNY's ability to maintain appropriate levels of bank reserves from week to week, diminish the FRBNY's ability to achieve reserve

growth objectives, and possibly accentuate interest rate volatility.

6. Repurchase agreements are an important method for dealer financing of their inventories of United States government securities. The primary dealers typically underwrite a sizeable portion of new Treasury issues—35-75 percent—and rely heavily on temporary financing through repurchase agreements pending resale of the issues to other investors. Clearly, an impairment of the repo market would make it less attractive for dealers to perform this very useful underwriting function, thus adding to Treasury interest costs.

7. Repurchase agreements are a major vehicle in the market-making process, providing the means for creating hedges and arbitrages among various issues and thereby increasing liquidity. Through these transactions, the dealer market adds to the close substitutability among Treasury issues, enhancing the attractiveness of the market for a variety of participants, which in turn increases the market for Treasury issues. If repurchase agreements were to lose their present characteristics of flexibility and liquidity, the dealer market—a critical element in the process of financing the national debt through Treasury issues—would be handicapped. More generally, a hobbling of the repo market could have broad rate effects throughout the financial markets, diminishing efficiency and the allocation of resources. Market participants would turn to less liquid forms of investment that would tend to produce higher rates in the economy at large. Greater volatility of rates as a consequence of a diminished repo market could add to average rate levels.

8. Repurchase agreements have proven to be invaluable to a wide variety of institutional investors, both public and private. A significant number of participants in the market are public entities who face constitutional, statutory, or regulatory restrictions on lending and borrowing activities, but can and do rely on repurchase agreements to achieve investment, cash management and liquidity needs. If repurchase agreements, with their present characteristics (including unencumbered

transferability of securities delivered under repo contract), and in their present form and as presently understood in the market (contracts for the sale and repurchase of securities) were unavailable to these participants in the market, the more costly financing alternatives would have adverse consequences for the entities involved, and their withdrawal from the government securities market as repurchase participants would adversely impact the market.

9. Repurchase agreements, as used and understood by the FRBNY in conformity with recognized and accepted market practice, are agreements for the transfer of securities with a simultaneously executed agreement to retransfer securities back to the original seller at a specified future date. They are structured and treated as sales and repurchases, unencumbered by any restriction from prior transfer that would impede further transfer. This treatment is essential to the purposes for which repurchase agreements are employed: high volume, short-term financing transactions.

/s/ PETER D. STERNLIGHT
Peter D. Sternlight

Subscribed and sworn
to before me this 11th
day of April, 1986
/s/ MARGARET M. MANUEL
MARGARET M. MANUEL
Notary Public

[ILLEGIBLE]
Notary Stamp

Supreme Court, U.S.
FILED
MAY 3 1994
OFFICE OF THE CLERK

No. 93-823

In The
Supreme Court of the United States
October Term, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE
Petitioner,
v.
JOHN LOEWENSTEIN,
Respondent.

On Writ of Certiorari to the Supreme Court of the State of Nebraska

BRIEF OF AMICI CURIAE ON THE MERITS IN SUPPORT OF THE STATE OF NEBRASKA, DEPARTMENT OF REVENUE BY THE STATE OF CALIFORNIA AND THE STATES OF ALABAMA, ARIZONA, DELAWARE, ILLINOIS, INDIANA, KENTUCKY, LOUISIANA, MARYLAND, MASSACHUSETTS, MICHIGAN, NEW HAMPSHIRE, NEW JERSEY, NEW MEXICO, NEW YORK, NORTH DAKOTA, OKLAHOMA, OREGON, UTAH, VERMONT, VIRGINIA AND WISCONSIN

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QUESTION PRESENTED

Whether 31 U.S.C. §3124(a) prohibits state taxation of distributions received by a shareholder of a mutual fund, when those distributions are derived from repurchase agreements involving a federal obligation.

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ARGUMENT 8

I SINCE THE NEBRASKA TAX TAXES NEITHER THE FEDERAL OBLIGATIONS THEMSELVES NOR THE INTEREST PAID BY THE GOVERNMENT, THERE IS NO EXEMPTION UNDER 31 U.S.C. §3124(a). 8

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No. 93-823

In The
Supreme Court of the United States
October Term, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE
Petitioner,
v.
JOHN LOEWENSTEIN,
Respondent.

On Writ of Certiorari to the Supreme Court of the State of Nebraska

BRIEF OF AMICI CURIAE ON THE MERITS IN SUPPORT OF THE STATE OF NEBRASKA, DEPARTMENT OF REVENUE BY THE STATE OF CALIFORNIA AND THE STATES OF ALABAMA, ARIZONA, DELAWARE, ILLINOIS, INDIANA, KENTUCKY, LOUISIANA, MARYLAND, MASSACHUSETTS, MICHIGAN, NEW HAMPSHIRE, NEW JERSEY, NEW MEXICO, NEW YORK, NORTH DAKOTA, OKLAHOMA, OREGON, UTAH, VERMONT, VIRGINIA AND WISCONSIN

INTEREST OF AMICI CURIAE

Amici are States of the United States. Under the laws of each amicus State,[1] a tax is imposed on income to the extent not prohibited by the Constitution or the laws of the United

[1] In New Hampshire, there is no general income tax but New Hampshire imposes a tax on certain income under its interest and dividends tax, to the extent not prohibited by the Constitution or laws of the United States.

States. Under 31 U.S.C. §3124(a), obligations of the United States and the interest thereon are exempt from state taxation.

This case involves important principles of federalism and could lead to unjustified limitations upon the power of the States to impose a tax which is neither prohibited by the U.S. Constitution nor in conflict with any federal law. If 31 U.S.C. §3124(a) is given the overly broad interpretation, as contemplated by the taxpayer in this case, the exemption could be extended to other nominal owners of federal obligations and other forms of income that consider the value of a federal obligation, without regard for the true economic substance of the transaction giving rise to the income taxed. Such a result would attribute an unwarranted talismanic power to federal obligations. The taxpayer's proposed interpretation of §3124(a) would result in discrimination against the States in violation of the doctrine of intergovernmental tax immunity.

Amici have a fiscal interest in the interpretation of 31 U.S.C. §3124. If this law is interpreted to prohibit state taxation of forms of income only remotely related to a federal obligation (i.e., gain on sale, repurchase agreement income, etc.), the income tax base in each State will be reduced substantially.

The decision by the Nebraska Supreme Court is at odds with rulings of other state courts around the country. The highest courts in six states have concluded that 31 U.S.C. §3124(a) does not prohibit state taxation of income from a repurchase agreement involving a federal obligation.[2] The

[2] *Comptroller of the Treasury v. First United Bank & Trust Co.*, 320 Md. 352, 578 A.2d 192 (Md. 1990); *Hammond Lead Products, Inc. v. State of Indiana Tax Commissioners*, 575 N.E.2d 998 (Ind. 1991); *Everett v. Department of Revenue and Finance*, 470 N.W.2d 13 (Iowa 1991); *Borg* (continued...)

appellate courts in three other states reached the same conclusion.[3] The issue is currently pending before the Supreme Court of California.[4] An intermediate appellate court in Michigan is the only other state court which has reached the same conclusion as the Supreme Court of Nebraska,[5] but that decision is not authoritative.[6] Amici have an interest in seeing the decisions of their courts sustained, particularly when a substantial amount of state tax has been collected on the basis of these decisions.[7]

[2](...continued)
v. Department of Revenue, 308 Or. 34, 774 P.2d 1099 (Or. 1989); *Massman Construction Company v. Director of Revenue*, 765 S.W.2d 592 (Mo. 1989); *In re Thomas C. Sawyer Estate*, 149 Vt. 541, 546 A.2d 784 (Vt. 1987).

[3] *Department of Revenue v. Page*, 541 So. 2d 1270 (Fla. Dist. Ct. App. 1989); *Capital Preservation Fund, Inc. v. Wisconsin Dep't of Revenue*, 145 Wis. 2d 841, 429 N.W. 2d 551 (Wis. Ct. App. 1988); *Andras v. Illinois Department of Revenue*, 154 Ill. App. 3d 37, 506 N.E.2d 439, 106 Ill. Dec. 732 (Ill. App. 1987), *cert. denied*, 485 U.S. 960 (1988).

[4] *Bewley v. Franchise Tax Board*, 15 Cal.App. 4th 310 (1993), pet. for rev. granted July 22, 1993, (S033257), reprinted at 20 Cal.App. 4th 534, to permit tracking pending disposition by the California Supreme Court.

[5] *Matz v. Department of Treasury*, 155 Mich. App. 778, 401 N.W.2d 62 (Mich. Ct. App. 1986).

[6] As pointed out in *Capital Preservation Fund, Inc., supra*, 429 N.W. 2d at 555, the reasoning of other state courts to the contrary is "far more persuasive on the issue than the Michigan court's unexplained *per curiam* quotation from a state agency ruling." In addition, the *Matz* decision has been distinguished even in Michigan. In *H.J. Heinz Co. v. Dept. of Treasury*, 494 N.W. 2d 850, 853 (Mich. App. 1992), the court "agree[d] with those courts which classify repo transactions as collateralized loans rather than purchases and sales."

[7] The present case is an action for declaratory judgment concerning the validity of a Nebraska regulation. It does not involve a claim for refund. As a result, the Nebraska courts did not address the extent to which their conclusions regarding 31 U.S.C. §3124(a) should be given (continued...)

Even if it were determined that section 3124(a) rendered the mutual fund's repurchase agreement income exempt in the hands of the mutual fund, that determination by itself would not require that the tax exemption be passed on to the shareholders of the mutual fund when the fund paid out dividends from the fund's income. A number of state courts around the country have also examined the question regarding the tax treatment of distributions to shareholders of mutual funds that own federal obligations. Contrary to the views expressed herein, several have concluded that 31 U.S.C. §3124(a) prohibits state taxation of distributions to shareholders of mutual funds, to the extent these distributions have their source in interest on federal obligations owned by the mutual fund.[8] No federal court has reached the same

[7](...continued)
retroactive effect.

The states, in reasonable reliance on the above consensus of the state court decisions, have collected a fiscally significant amount of taxes. If this Court were to reach a decision in this case against petitioner Nebraska, it is unclear whether, under the laws of Nebraska and the Constitution, the respondent would be entitled to a refund of taxes paid. Because of *Harper v. Virginia Department of Taxation*, 509 U.S. ___, 113 S.Ct. 2510, 125 L.Ed.2d 74 (1993), a flat affirmance of the Nebraska decision might give rise to the contention that all other states would be bound to give retroactive relief, to the extent such relief was not procedurally barred. Amici submit that if any holding were to be made against Nebraska, the case should be remanded to the Nebraska courts for consideration of how such a holding should be applied. See *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco, Dept. of Business Regulation of Florida, et al*, 496 U.S. 18, 32 n. 16 (1990).

[8] *Yurista v. Commissioner*, 460 N.W.2d 24 (Minn. 1990); *Andras v. Illinois Dept. of Revenue, supra; Matz v. Department of Revenue, supra; Capital Preservation Fund, Inc. v. Wisconsin Dep't of Revenue, supra.*, relied exclusively on 31 U.S.C. §3124(a) and the Investment Company Act of 1940 to invalidate state taxation of distributions paid to shareholders of mutual funds that receive interest on federal obligations exempt from state
(continued...)

conclusion for federal tax purposes. Most amici have an interest in an authoritative resolution by this Court of the question of whether a tax exemption enjoyed by mutual funds is automatically passed on to their shareholders when the funds' income is distributed to the shareholders in the form of dividends.

STATEMENT PURSUANT TO RULE 37

This brief is submitted pursuant to Rule 37.3 of this Court in support of petitioner, State of Nebraska, Department of Revenue. Consent to the filing of this brief has not been requested from the parties because amici filing this brief are the Attorneys General of their respective States. Rule 37.5 U.S. Sup. Ct.

SUMMARY OF ARGUMENT

Federal law, i.e., 31 U.S.C. §3124(a), prohibits state taxation of an obligation of the United States or the interest thereon. This prohibition extends to every form of taxation that requires the obligation, or the interest thereon, or both,

[8](...continued)
tax.

In other cases, i.e., *Comptroller of the Treasury v. First United Bank & Trust Co, supra; Borg v. Department of Revenue, supra; Brown v. Franchise Tax Board*, 197 Cal. App. 3d 300, 242 Cal. Rptr. 810 (1987); *In re Thomas C. Sawyer Estate, supra;* the courts invalidated state taxation of distributions paid to shareholders of mutual funds on the basis of 31 U.S.C. §3124(a) *and* the doctrine of intergovernmental tax immunity. In these cases, state law provided an exemption for distributions to shareholders of mutual funds that owned state obligations but did not provide a similar exemption for mutual funds that owned federal obligations. (The unpublished portion of *Brown, supra*, discusses the discriminatory nature of the former California statute.)

to be considered, directly or indirectly, in the computation of the tax.

Respondent is a shareholder of a mutual fund that distributed amounts attributable to the "interest" income the fund received from repurchase agreements involving federal obligations. A repurchase agreement is a financing arrangement in which the owner of a marketable security — in this case a federal obligation — temporarily relinquishes nominal ownership of the security and agrees to pay "interest" to a lender. The agreement, cast as a sale and repurchase, specifies the sale price and the repurchase price of the security, both of which are less than the market value of the obligation at the time of the agreement. The repurchase price includes a premium, frequently labeled "interest," which reflects prevailing interest rates for loans with similar collateral. The use of the term "interest" for this premium amount only reflects that this repurchase agreement is, in substance, a loan agreement wherein the mutual fund has made a loan and holds federal obligations as a form of security to ensure repayment of that loan with preset interest.

This "interest" — paid by the borrower (nominal seller) to the lender (nominal purchaser), the mutual fund in this case — provided the source of mutual fund income which was subsequently paid to shareholders of the mutual fund in the form of dividends. It is these dividends which the Nebraska Supreme Court has wedged into the immunity provided to federal obligations under 31 U.S.C. § 3124(a).

There is no reason to believe that a venerable principle of tax jurisprudence — that tax treatment should be based on economic substance rather than labels — is not applicable for purposes of exemption from state taxation pursuant to 31 U.S.C. §3124(a). The income subject to Nebraska tax in this

case is, in substance, interest paid by a private party on a loan which uses a federal obligation for collateral. Nebraska is not taxing a federal obligation or the interest thereon. The computation of the tax on income from a repurchase agreement does not require consideration of a federal obligation or the interest thereon. Consequently, the tax is not prohibited by 31 U.S.C. §3124(a).

Even if this loan arrangement were to be treated, from the standpoint of the lender, as a true purchase followed by a sale of the underlying federal obligation, the Nebraska state tax would only be taxing the gain on the resale of the federal obligation. Interest paid by the United States on a federal obligation is the only form of income that is exempt from state taxation under 31 U.S.C. §3124(a). This federal law does not prohibit state taxation of gain on the sale of a federal obligation.

Even if 31 U.S.C. § 3124(a) were to be construed to prohibit state taxation of income from a repurchase agreement involving a federal obligation, neither the Investment Company Act of 1940 nor 31 U.S.C. §3124(a) prohibits state taxation of a dividend paid to the shareholders of a mutual fund that is attributable to this income. A dividend distribution to a shareholder of a mutual fund is not interest on a federal obligation nor is it income from a repurchase agreement involving a federal obligation. Unless state law provides otherwise, a shareholder of a mutual fund is subject to state income tax on a distribution from the mutual fund, even if the income of the mutual fund includes interest on a federal obligation.

The doctrine of intergovernmental tax immunity does not prohibit nondiscriminatory state taxation of gain on the sale of a federal obligation, of income from a repurchase agreement

involving a federal obligation, or of a distribution from a mutual fund that owns a federal obligation. Moreover, prohibiting state taxation of such income while permitting federal taxation of identical income when a state obligation is involved would discriminate against the States in violation of the Constitution.

The decision of the Nebraska Supreme Court should be reversed.

ARGUMENT

I

SINCE THE NEBRASKA TAX TAXES NEITHER THE FEDERAL OBLIGATIONS THEMSELVES NOR THE INTEREST PAID BY THE GOVERNMENT, THERE IS NO EXEMPTION UNDER 31 U.S.C. §3124(a).

A. IN SUBSTANCE, THE REPURCHASE AGREEMENTS WERE LOANS; INTEREST PAID BY A PRIVATE PARTY ON A LOAN CANNOT QUALIFY FOR INCOME TAX EXEMPTION UNDER 31 U.S.C. §3124(a).

For the years in question, Section 3124(a), Title 31, United States Code, provided as follows:

> Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to

> be considered in computing a tax.[9]

For purposes of tax law, the primary consideration in determining the proper tax treatment of a particular transaction is economic substance of the transaction rather than its form. In cases where the legal characterization of economic facts is decisive, the principle is well established that the tax consequences should be determined by the economic substance of the transaction, not the labels put on it for other purposes.

> In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding.[10]

A repurchase agreement is a financing arrangement where the owner of a marketable security — in this case a federal obligation — relinquishes nominal ownership of the security in an agreement purporting to sell and simultaneously repurchase the same security at a later date. The agreement specifies the sale price and the repurchase price, both of which are less than the market value of the obligation at the time of the agreement. The repurchase price includes a premium, frequently labeled "interest," which reflects prevailing interest rates for loans with similar collateral at the time of the agreement rather than the stated rate of interest on

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[9] This reflects a 1982 reformulation of Rev. Stat. §3701, as amended, (31 U.S.C. §742). In 1959, the second sentence was added to Rev. Stat. §3701 as follows:

> This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax . . . (Pub. L. 86-346, §105(a), 73 Stat. 622 (1959).

In 1982, the words "directly or indirectly" were "omitted as surplus." H.R. Rep. No. 97-651, 97th Cong. 2d Sess. 94 (1982).

[10] *Helvering v. F. & R. Lazurus & Co.*, 308 U.S. 252, 255 (1939).

the underlying security.[11]

Repurchase agreements similar to those involved in the present case have repeatedly been held to be, for federal income tax purposes, secured loans rather than true sales and repurchases.[12] Although the transactions involved in the present case are, in form, a purchase and sale by the fund, the fund does not bear the risk or receive the benefit of changes in the market values of the federal obligations during the time of the fund's nominal ownership of the obligation. Purchase of the obligation by the fund, coupled with the seller-borrower's simultaneous contractual commitment to repurchase the obligations on a specific future date at the original sale price, plus "interest", regardless of the market value of such obligations on that date, insulates the fund from the possibility of any loss or gain because of a change in market value of the federal obligation.

The "interest" element in the repurchase agreement does not in any way represent interest paid by the United States in

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[11] For a detailed discussion of a repurchase agreement see *Security and Exchange Commission v. Miller*, 495 F.Supp. 465 (1980), and M. Stigum, *The Money Market: Myth, Reality, and Practice* (Dow-Jones Irwin 1978).

[12] *First American National Bank of Nashville v. United States*, 467 F.2d 1098 (6th Cir. 1972) (purchaser of municipal bonds in repurchase agreement was not owner thereof entitled to interest exemption under Internal Revenue Code §103(a)); *Union Planters National Bank of Memphis v. United States*, 426 F.2d 115 (6th Cir. 1970), *cert. denied* 400 U.S. 827 (1970) (same); *American National Bank of Austin v. United States*, 421 F.2d 442 (5th Cir. 1970), *cert. denied* 400 U.S. 819 (1970) (same); *but see, American National Bank of Austin v. United States*, 573 F.2d 1201 (Ct. Cl. 1978) (purchaser bore sufficient risk of ownership to be treated as owner for purposes of I.R.C. §103(a)); *Citizens National Bank of Waco v. United States*, 551 F.2d 832 (Ct.Cl. 1977) (same). *See also* Rev. Rul. 74-27, 1974-1 C.B. 24 (purchaser of municipal bonds in repurchase agreement was not the owner thereof for purposes of I.R.C. §103(a)).

consideration of the use of money furnished to it by the nominal purchaser in the repurchase agreement.[13] Instead, this interest represents the consideration paid by the borrower to the fund for the use of its money (the "purchase price") during the term of the repurchase agreement. Such "interest" is not based on or otherwise attributable to interest paid by the United States but instead, is determined by market interest rates for loans of comparable duration that are secured by federal obligations. Although the fund's rights with respect to the federal obligations that are the subject of the repurchase contracts may be different for bankruptcy purposes,[14] for tax purposes, these rights are indistinguishable from the rights of a lender holding such obligations as collateral for a loan.[15]

Courts in Florida, Illinois, Indiana, Iowa, Maryland,

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[13] The repurchase agreements involved herein provided that interest on the federal obligation remained the property of the seller-borrower. In the federal cases which examined repurchase agreements, (note 12, *supra*) state interest was paid to the nominal owner of the state obligations. In those cases, like the state cases, the borrower (substantive owner) received the economic benefit of governmental interest.

[14] In 1982, the United States District Court of the Southern District of New York concluded that repurchase agreements were collateralized loans for bankruptcy purposes. *Lombard-Wall Inc. v. Columbus Bank & Trust Co. (In re Lombard-Wall,Inc.)*, No. 82 B 11556 (Bankr.S.D.N.Y. Sept. 16, 1982). As a result, repurchase agreements could not be liquidated by selling the securities in violation of the automatic stay provisions of the Bankruptcy Code. In response to *Lombard-Wall*, the Congress enacted 11 U.S.C. §559 which provides that "[t]he exercise of a contractual right of a repo participant to cause the liquidation of a repurchase agreement . . . shall not be stayed, avoided or otherwise limited by operation of any provision of this title[.]" As a result, bankruptcy of a borrower-repurchaser will not prevent a lender from selling a federal obligation which was the subject of a repurchase agreement.

[15] See *Comptroller of the Treasury, Income Tax Division v. First United Bank & Trust Co.*, 320 Md. 352, 578 A.2d 192, 201 (1990). The terms of the repurchase agreements involved in *Comptroller v. First United Bank, supra*, are identical to those at issue in the present case.

Missouri, Oregon, Vermont and Wisconsin have examined this issue. All have used the above reasoning to agree that repurchase agreements like the agreements in this case should be treated as the loans they truly are. See notes 2 and 3, *supra*.

Respondent does not dispute the nominal nature of repurchase agreement ownership. Rather, respondent, relying on expressions by this Court in *American Bank & Trust Co. v. Dallas County*,[16] has claimed 31 U.S.C. §3124(a) provides a "broad" and "sweeping" exemption from any state taxation that diminishes "in the slightest degree" the marketability and investment attractiveness of federal obligations. The Nebraska court embraced these expressions as well.

Section 3124(a) and the effects of the 1959 amendment are the focus of *American Bank & Trust Co. v Dallas County*. "The 1959 amendment rejected and set aside th[e] Court's rather formalistic pre-1959 approach to §3701. . . . Under the plain language of the 1959 amendment, however, the tax is barred regardless of its *form* if federal obligations must be considered, either directly or indirectly, in *computing* the tax." *American Bank*, supra, 463 U.S. at 862, (emphasis in original).

There is absolutely nothing in the history of 31 U.S.C. §3124(a) or the 1959 amendment to indicate the Congress intended to do anything other than abandon formalistic distinctions between acceptable and unacceptable forms of state taxation of federal obligations.

The income subject to Nebraska tax in this case is, in substance, interest paid by a private party on a loan which uses a federal obligation for collateral. It is not a tax on a

[16] 463 U.S. 855 (1983).

federal obligation or the interest thereon and, as a result, is not prohibited by 31 U.S.C. §3124(a).

B. EVEN IF THE MUTUAL FUND'S INCOME FROM A REPURCHASE AGREEMENT WERE TO BE SEEN AS INCOME FROM THE SALE OF A FEDERAL OBLIGATION RATHER THAN INTEREST ON A LOAN SECURED BY A FEDERAL OBLIGATION, INCOME FROM THE SALE OF A FEDERAL OBLIGATION IS NOT EXEMPT FROM STATE TAXATION UNDER 31 U.S.C. §3124(a).

Respondent Loewenstein argues that the tax in question here is prohibited by 31 U.S.C. §3124 because the state tax on this income requires consideration of, at least indirectly, an obligation of the United States, the interest thereon, or both. As a result, such tax purportedly is prohibited by 31 U.S.C. §3124(a). The Nebraska Supreme Court said as much. "[T]he income received by the [respondent] in this case, at the very least, is considered indirectly in computation of the tax."[17]

The respondent has argued further that 31 U.S.C. §3124(a) prohibits state taxation of income from a repurchase agreement involving a federal obligation because, when a repurchase agreement is viewed as the purchase and sale of a federal obligation, income is realized by the lender when the obligation is repurchased (sold, from the point of view of the lender). This income is the difference between the purchase

[17] *Loewenstein v. Nebraska Dept. of Revenue*, 244 Neb. 82, 90, 504 N.W.2d 800, 805 (1993), Pet. for Cert., Appendix A, at A-13.

price paid for the federal obligation and the sale price of the obligation when it is subsequently sold several days or weeks later to the original seller. There is no doubt that income exists at the time of the repurchase; however respondent's argument is based on the assumption that 31 U.S.C. §3124(a), as amended in 1959, prohibits state taxation of gain on the sale of a federal obligation. This is not correct.

In 1931, limitations on state and federal taxation imposed by the constitutional doctrine of intergovernmental tax immunity were at their historical apex. The federal government could not impose a tax on state employees,[18] state obligations, or the interest thereon.[19] Similarly, states could not impose a tax on a federal obligation or the interest thereon.[20]

Then, in *Willcuts v. Bunn*, 282 U.S. 216 (1931), a unanimous Court approved federal taxation of gain on the sale of a state obligation that was exempt from federal tax. Chief Justice Hughes, addressing taxation of gain on the sale of an exempt obligation, observed:

> The sale of bonds by their owners, after they have been issued by the state or municipality, is a transaction distinct from the contracts made by the government in the bonds themselves, and the profits on such sales are in a different category of income from that of the interest payable on the bonds.[21]

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[18] *Collector v. Day*, 78 U.S. (11 Wall.) 113 (1871), overruled by *Graves v. New York ex rel*, 306 U.S. 466 (1939).

[19] *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), overruled *South Carolina v. Baker*, 485 U.S. 505 (1988).

[20] *Weston v. City Council of Charleston*, 27 U.S. (2 Pet.) 449 (1829); and Rev. Stat. §3701, 31 U.S.C. §742.

[21] *Willcuts, supra*, 282 U.S. at 227.

The Court relied to a substantial extent on long-established practice. "This practice clearly indicates that neither the Federal government nor the states have found a tax on the profits of the sales of their securities to be a burden on their power to borrow money. So far as we are advised, the Federal government has not at any time deemed it to be necessary to exempt from taxation the profits realized by owners on the sale of its obligations . . . ."[22] At that time, state obligations and the interest thereon were exempt from federal taxation. Federal obligations and the interest thereon were exempt from state taxation and some federal taxes. Thus, the conclusion in *Willcuts* is equally applicable to state taxation of gain on the sale of a federal obligation.

The Court also took note of Federal regulations[23] and the by-then well established Congressional practice to explicitly identify gain on the sale of a federal obligation if such income were to be exempt from taxation.[24] Certainly before 1959, gain on the sale of a federal obligation was not exempt from state taxation.[25]

The 1959 amendment is discussed in the unanimous decision in *First National Bank of Atlanta v. Bartow County*

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[22] *Ibid*, at 232.

[23] O.D. 729, Cumulative Bulletin No. 3, July-December, 1920, pp. 123, 124. See *Willcuts, supra*, 282 U.S. at 230-231, note 5.

[24] The Court, at footnote 5 in *Willcuts, supra*, 282 U.S. at 230-231, describes the legislative progress of the Act of June 17, 1929, Ch. 26, 46 Stat. at L. 19, 20, and the enactment of the Act of June 7, 1930, Ch. 512, 46 Stat. at L. 775. In both cases, *gain from the sale or other disposition* of a federal obligation was specifically identified as an object of exemption.

[25] See *United States v. Stewart*, 311 U.S. 60 (1940); *Stern Bros. & Co. v. Commissioner*, 108 F.2d 309 (8th Cir. 1940); *Lloyd v. Commissioner*, 154 F.2d 643 (3rd Cir. 1946); *Central Hanover Bank & Trust Co. v. United States*, 83 Ct. Cl. 401, 14 F.Supp. 541 (1936); and *Agricultural Sec. Corp. v. Commissioner*, 39 B.T.A. 1103 (1939).

Board of Tax Assessors, 470 U.S. 583, 589 (1985). By enacting the 1959 amendment, "Congress intended to abolish the formalistic distinction between taxes *on* income and taxes *measured by* income. . . . [N]othing in the legislative history indicat[es] that Congress understood the addition actually to broaden the scope of the exemption, as well as to clarify the forms of taxes to which the exemption applied."[26] Certainly income tax is not a new or unique form of tax.

The factors that influenced the Court in *Willcuts* are equally persuasive today. Federal taxation of gain on the sale of a state obligation remains permissible. More importantly, the Congress knows how to extend a tax exemption to gain on a sale of an obligation and has done so in other contexts.[27]

Interest on a federal obligation has always been exempt from state income tax. There is no indication the 1959 amendment was intended to expand the objects of exemption to include gain on the sale of a federal obligation. The exemption provided by section 3124(a) continues to be limited to an obligation of the United States and the interest thereon.

Since 31 U.S.C. §3124(a) does not prohibit state taxation of gain on the sale of a federal obligation by a substantive owner, even if a repurchase agreement were really a sale of a federal obligation rather than a collateralized loan, income from a repurchase agreement, as gain on the sale of a federal

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[26] *First National Bank of Atlanta, supra*, at 594 (emphasis in original).

[27] See note 24, supra. In addition, 31 U.S.C. §3124(b) explicitly refers to gain on the sale of a federal obligation in connection with obligations issued by the Federal Home Loan Bank Board. "The tax status of interest on obligations and dividends, earnings, or other income from evidences of ownership issued by the Government or an agency and *the tax treatment of gain and loss from the disposition of those obligations* and evidences of ownership is decided under the Internal Revenue Code . . . ." 31 U.S.C. §3124(b) (emphasis added).

obligation, would not be exempt from state taxation.

C. NO MATTER WHAT TAX EXEMPT INCOME A MUTUAL FUND MIGHT DERIVE IN CONNECTION WITH FEDERAL OBLIGATIONS, THE FACT THAT SUCH INCOME PROVIDES THE SOURCE FOR A DISTRIBUTION BY THE FUND TO ITS SHAREHOLDER DOES NOT RENDER THE DISTRIBUTION EXEMPT FROM STATE TAXATION UNDER 31 U.S.C. §3124(a).

Petitioner conceded below that 31 U.S.C. §3124(a) prohibits state taxation of distributions received by the respondent as shareholder of a mutual fund to the extent such distributions are traceable to interest on a federal obligation. Several state courts have concluded likewise.[28] The Nebraska Supreme Court did not consider the issue.

However, for the question presented to be fully answered in favor of the taxpayer, there would need to be at least two determinations: (1) that the income in the hands of the mutual fund was exempt under section 3124(a); and (2) that this tax immunity enjoyed by the mutual fund somehow was passed through to its shareholders when the mutual fund later made dividend distributions.

It is amici's position that, unless a state's law provides otherwise, section 3124(a)'s tax exemption cannot be passed through from the mutual fund (which actually received the

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[28] Note 8, *supra*.

income in question) to its shareholders.[29] This result would obtain whether the facts in a particular case involved (as in this case) the fund's income from repurchase agreements or (as in cases such as *Brown v. Franchise Tax Board* and other cases cited above at note 8) the interest income received by the fund from the federal government on federal obligations owned by the fund.

Courts that have determined mutual fund shareholders share the benefits of section 3124(a) have relied on two federal laws — 31 U.S.C. §3124(a) and the Investment Company Act of 1940[30]. This reliance is misplaced.

As explained by the Court in *First National Bank of Atlanta v. Bartow County Board of Tax Assessors*, *supra*, and *Rockford Life Insurance Company v. Illinois Department of*

[29] Section 3124(a) of Title 31, United States Code, does not mandate an exemption from state taxation for a dividend paid to the shareholder of a mutual fund even if the fund owns a federal obligation and receives interest thereon. However, any state may (and several states do) provide an exemption from state taxation for dividends from a mutual fund. For example, under section 17145 of the Revenue and Taxation Code of California, a mutual fund with at least 50 percent of its total assets invested in federal obligations is permitted to pay exempt-interest dividends to its shareholders. Exempt-interest dividends received by shareholders are exempt from California's personal income tax. The amount of exempt-interest dividends is based on total interest received on exempt obligations, reduced by expenses attributable thereto. See also New York Tax Law § 612(c)(1).

[30] Some state courts have also invalidated state taxation of distributions received by shareholders of mutual funds that own federal obligations because the state tax discriminated against funds which invested in federal obligations. In these cases, distributions from mutual funds related to the receipt of interest on state obligations were exempt from state taxation, while comparable distributions related to the receipt of interest on federal obligations were not. This was viewed, correctly, as a violation of the doctrine of intergovernmental tax immunity discussed *infra*.

Revenue,[31] the 1959 amendment to 31 U.S.C. §3124(a) was intended to eliminate formalism in distinguishing between acceptable and unacceptable *forms* of taxation that were under consideration by the states (Idaho in particular) to circumvent the prohibitions of §3124(a).

In *American Bank and Trust*, *supra*, 463 U.S. at 855, this Court concluded that a bank shares tax (a form of property tax), nominally imposed on bank shareholders (but paid by the bank), and computed on the basis of the net assets of the bank, was prohibited by 31 U.S.C. §3124(a), as amended in 1959, because the value of federal obligations was included in the measure of the tax. This decision did not hold that shareholders of a corporation are entitled to an exemption from state income tax for otherwise taxable distributions from the corporation because the corporation owns federal obligations and receives tax exempt interest thereon. Extending 31 U.S.C. §3124(a) to prohibit a state income tax on shareholders of mutual funds that own federal obligations requires ignoring a traditionally significant tax paying entity — a corporation.[32] In this context it would be inappropriate to discard the significant distinctions that exist between a shareholder and a corporation in the name of eliminating formalism concerning state taxation of federal obligations.

The courts which have granted exemption to mutual fund shareholders have concluded that exemption under 31 U.S.C. §3124(a) is passed through to shareholders of a mutual fund because a mutual fund is different from other corporations.

[31] 482 U.S. 182 (1987).

[32] This Court has concluded that "a corporation is a nonconductor that cuts off connection between dividends to its stockholders and the corporate funds from which the dividends are paid." *Miller v. Milwaukee*, 272 U.S. 713, 714 (1927).

These arguments and decisions invariably rely on this Court's description of a mutual fund in *Burks v. Lasker*[33] as "a pool of assets, consisting primarily of portfolio securities, and belonging to the individual investors holding shares in the fund." This reliance is not justified.

Burks was not remotely related to taxation or factors relevant to tax determinations. It addressed the ability of disinterested directors to terminate a shareholder's derivative suit under the Investment Company and Investment Advisers Acts (15 U.S.C. §§80a-1 et seq. and 80b-1). The nature of a shareholder's ownership interest in the securities owned by the fund was not examined in or determinative of the Court's holding.

The Investment Company Act of 1940 established federal authority for a registered investment company, commonly referred to as a mutual fund. A mutual fund engages primarily in the business of investing, reinvesting, or trading in securities. It is authorized to issue securities[34] that reflect ownership of the company and is classified as a corporation for tax purposes.[35]

The Investment Company Act does not provide special tax treatment for shareholders of mutual funds that invest in tax exempt obligations. In 1976, more than thirty years after enactment of the Investment Company Act, the Internal Revenue Code was amended to allow certain mutual funds to

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[33] 441 U.S. 471, 480 (1979).

[34] See 15 U.S.C.A. §80a-3(a)(1) for definition. Although the investment companies involved herein were organized as Massachusetts business trusts, this distinction is not relevant to the issues involved herein because such a trust, like an investment company, is treated as an association for income tax purposes and taxed as a corporation.

[35] See Internal Revenue Code sections 851(a)(1) and 852(b).

pay tax-exempt distributions.[36] Before that time, distributions from all mutual funds to shareholders, even though attributable to interest on a state obligation owned by the fund, were subject to federal income tax.

Thus when the Congress wanted to provide preferential treatment for distributions of mutual funds that invested in state obligations, it did so by providing a special statutory regime — tax exempt distributions.[37] Mutual funds that meet certain requirements are permitted to pay tax-exempt distributions. Shareholders are not subject to income tax on tax-exempt distributions. These rules have the effect of pass-through treatment when the statutory conditions are met. They do not, however, establish any general rule that shareholders of a mutual fund should be treated as if they were owners of the assets of the fund for federal tax purposes. In fact, the Congress has concluded that shareholders of mutual funds are not owners of assets owned by the fund for tax purposes.[38]

The Nebraska Supreme Court's holding of exemption from state taxation for mutual fund distributions necessarily is based on a broad and sweeping interpretation of 31 U.S.C. §3124(a). Under this interpretation, every dollar of a mutual fund distribution traceable to federal interest would be exempt from state taxation. This overly broad interpretation is

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[36] See Section 2137, Tax Reform Act of 1976, Pub. L. 94-455, which added sections 265(a)(3) and 852(b)(5) to the Internal Revenue Code, (Title 26, United States Code).

[37] As defined in Internal Revenue Code §852(b)(5), as added by §2137(c), Pub. L. No. 94-455, 90 Stat. 1520.

[38] See *General Explanation of the Tax Reform Act of 1976* (H.R. 10612) 94th Congress, Public Law 94-455, Joint Committee on Taxation, JCS-33-76, p. 678-679, 1976-3 C.B. vol. 2, p. 690-691.

inconsistent with the very exact approach which Congress has taken when actually dealing with mutual fund distributions. As to taxation of income from state obligations, section 852 of the Internal Revenue Code limits exempt interest distributions from mutual funds to net interest (state interest reduced by expenses attributable thereto) and then only if the mutual fund retains a minimum of 50 percent of its total assets invested in state obligations.

Amici do not question the value of mutual funds to the nation's economy and individual investors. However, to exempt from state taxation the distributions from mutual funds which own federal obligations solely on the basis of 31 U.S.C. §3124(a), without a clear statutory basis for not extending the same treatment to other entities such as normal corporations, pension funds,[39] etc., creates a dangerous precedent. Furthermore, unjustified erosion of the income tax base for the States will become more likely and be more difficult and burdensome to resist.

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[39] The argument that a pension payment is exempt from state taxation on the basis of 31 U.S.C. §3124(a) because the pension fund owned federal obligations was examined and specifically rejected by the Minnesota Supreme Court in *Meunier v. Minnesota Department of Revenue*, 503 N.W. 2d 125 (Minn. 1993). The court considered the fact that pensions paid by plans with funds invested in state obligations were not exempt from federal income tax even though interest received on these obligations is exempt from federal income tax under I.R.C. §103(a). Given these circumstances, the court concluded that an interpretation of 31 U.S.C §3124(a) that would prohibit state taxation of pensions from plans which invest in federal obligations and receive interest thereon "would . . . constitute a violation of the doctrine of intergovernmental tax immunity . . . .", 503 N.W. at 131.

II

PROHIBITING THE STATE TAXATION AT ISSUE WOULD VIOLATE THE DOCTRINE OF INTERGOVERNMENTAL TAX IMMUNITY.

A. DISCRIMINATORY TAXATION IS PROHIBITED.

In general, the doctrine of intergovernmental tax immunity emanates from the duality of sovereignty in our federal system. It was first articulated in *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819), where a state tax imposed on a national bank was held to be unconstitutional. Ten years later, the doctrine was interpreted to prevent state taxation of interest on a federal bond. A state tax on interest from a federal bond was "thought by th[e] court to be a tax on the contract, a tax on [government's] power to borrow money . . . and consequently to be repugnant to the Constitution." *Weston v. City Council of Charleston*, 27 U.S. (2 Pet.) 449, 469 (1829). Similarly, interest on state obligations was exempt from federal taxation. *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), overruled *South Carolina v. Baker*, 485 U.S. 505 (1988).

At one point, the doctrine was expressed as follows: "neither the Federal nor the State Governments could tax income an individual directly derived from any contract with another government." See the discussion of the evolution of the doctrine in *South Carolina v. Baker*, *supra*, 485 U.S. at 517. Taxing the income from a contract was considered to be a tax on the contract and the parties to the contract. Since one of the parties to the contract was the other government, the

tax was unconstitutional.[40] As a reflection of this rule, "it was also unconstitutional [for the federal government] to tax a state employee on income earned from his employment contract, *Collector v. Day*, 78 U.S. (11 Wall.) 113 (1871), to tax a lessee on income derived from lands leased from a State, *Burnet v. Coronado Oil*, 285 U.S. 393 (1932), or to impose a sales tax on proceeds a vendor derived from selling a product to a state agency, *Indian Motorcycle Co. v. United States*, 283 U.S. 570 (1931). Income derived from the same kinds of contracts with the Federal Government were likewise immune from taxation by the States."[41]

The scope of immunity began to diminish in the 1930s. Under the modern doctrine of intergovernmental tax immunity, the States can never tax the United States directly but can tax any private parties with whom it does business, so long as the tax does not discriminate against the United States or those with whom it deals. Likewise, the Federal Government can tax any private parties with whom the State does business, so long as the tax does not discriminate against the States.[42] In the modern era of intergovernmental tax jurisprudence, a federal tax imposed on those who deal with the States has survived constitutional scrutiny because the tax did not discriminate against the States.[43]

It has been a principle of tax immunity jurisprudence that

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[40] As pointed out in *South Carolina v. Baker*, at footnote 11, 485 U.S. at 517, the sources and scope of tax immunity of the federal government and state governments are different.

[41] *South Carolina v. Baker*, supra, 485 U.S. at 517.

[42] *South Carolina v. Baker, supra*, 485 U.S. at 523.

[43] See *South Carolina v. Baker, supra*, 485 U.S. at 527; *Helvering v. Mountain Producers Corp.*, 303 U.S. 376, 386-387 (1933); *Graves v. New York ex rel*, 306 U.S. 466, 485 (1939).

the rules for determining whether a particular tax offends the immunity of the other sovereign are the same for the federal government and the States. This is not to say that scope of immunity is exactly coextensive. Certainly, the federal government can enact a statute that extends the immunity provided by the Constitution,[44] so long as it does so in a manner that does not discriminate against the States. The notion of parallel treatment has been most recently articulated in *South Carolina v. Baker*.

> [F]ederal and state tax immunity cases have always shared the identical methodology for determining whether a tax is "on" a government, and . . . this identity has persisted even though the methodology for both federal and state immunities has changed as intergovernmental tax immunity doctrine shifted into the modern era.[45]

In *Davis v. Michigan Dept. of Treasury*,[46] the Court examined exemptions from state taxation for retired state employees. Discrimination in favor of those who were employed by a state, coupled with the absence of similar treatment for those who were employed by the United States, was unconstitutional because it discriminated against the United States.[47] *Davis* also stands for the principle that the

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[44] An example would be the immunity from state taxation provided by the Soldiers' and Sailors' Civil Relief Act, 50 U.S.C.App. §514. This federal law, among other limitations on state taxation, prevents a state from imposing a personal property tax on personal property located within a State if the property is owned by a member of the armed forces who is domiciled in another State and located within the taxing State solely due to military orders.

[45] Footnote 11, *South Carolina v. Baker, supra*, 485 U.S. at 518.

[46] 489 U.S. 803 (1989).

[47] *Davis, supra*, 489 U.S. 814-817.

doctrine of intergovernmental tax immunity prohibits discriminatory tax exemptions. In *Davis*, the Court concluded that the Constitution required federal retirees be treated equally with state retirees. Two remedies were available to Michigan — extend preferential treatment to federal retirees or repeal preferential treatment for state retirees.

Similar concerns motivated several state courts which have examined discriminatory state taxation of distributions from mutual funds.[48] In those cases, the courts applied the doctrine of intergovernmental tax immunity to strike down the respective discriminatory state statutes. If, however, a state tax does not discriminate against the United States or those who dealt with it (such as mutual funds that dealt with federal obligations), it would not violate the doctrine of intergovernmental tax immunity.

B. FEDERAL TAX TREATMENT OF STATE OBLIGATIONS.

Since the rules of intergovernmental immunity are essentially the same for both the States and the Federal Government, tax exemption in favor of those who deal with the United States is unconstitutional unless similar treatment is extended to those who deal with the States on the same basis.[49]

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[48] See second paragraph, note 8, *supra*.

[49] Although the rationale for the immunity of the federal government and the States may be different, the Court has never articulated a different measure of discrimination to gauge the constitutionality of a State statute imposing a state tax on those who deal with the United States and a federal statute granting exemption from state taxation for those who deal with the United States.

For example, Congress cannot exempt income from federal contracts from state taxation unless it also provides a comparable exemption from federal taxation for income from similar state contracts. Since the federal government cannot tax those who deal with the states in a way that discriminates against the states, and since the federal tax exemption for income from state obligations is subject to conditions which would not be present in respondent's application of 31 U.S.C. §3124(a) as to federal obligations, respondent's interpretation of that section would violate intergovernmental tax immunity.[50]

Federal law does not prohibit federal taxation of income from a repurchase agreement involving a state obligation, distributions from a mutual fund traceable to interest on a state obligation or gain on the sale of a state obligation. If federal law is interpreted to prohibit state taxation of this same income when federal obligations are involved, federal obligations will be more attractive than state obligations as investments, discriminating in favor of federal obligations and against the States.

C. SPECIAL CONSIDERATIONS APPLICABLE TO INTERGOVERNMENTAL TAXATION.

Citing *Smith v. Davis*,[51] respondent has argued that "the

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[50] The Minnesota Supreme Court concluded that an interpretation of 31 U.S.C. §3124(a) which provided preferential treatment for pension plans that invest in federal obligations when pension plans that invest in state obligations were not provided comparable treatment for federal tax purposes was a violation of the doctrine of intergovernmental tax immunity. See the discussion at note 39, supra.

[51] 323 U.S. 111 (1944).

long established Congressional intent [of §3124 is] to prevent taxes which diminish in the slightest degree the market value or investment attractiveness of obligations issued by the United States in an effort to secure necessary credit."[52] Respondent's citation to *Smith v. Davis* ignores the context within which it was expressed. The question in *Smith v. Davis* was whether §3701 (the predecessor of §3124) would prohibit a state tax that included the contract liability of the federal government to a government contractor in the measure of the tax. The Court concluded that §3701 did not prohibit such state taxation because the obligation was not included within the objects that were exempted by §3701 — it was not an obligation of the United States for purposes of §3701.

In *Rockford Life Ins. Co. v. Ill. Dept. of Revenue*, *supra*, the Court had no difficulty rejecting a claim that the state tax should be invalidated because it would have an economic effect on the United States. *Alabama v. King & Boozer*,[53] *Graves v. New York ex rel*,[54] and *James v. Dravo Contracting Co.*,[55] support the notion that economic effect is not determinative. All three are cited with approval for this proposition by the Court in *Rockford*.[56] "Immunity from taxation 'may not be conferred simply because the tax has an effect on the United States.' [citing] *United States v. New Mexico*, 455 U.S. 720, 734 (1982)."[57]

More importantly, the holding and rationale in *Smith v.*

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[52] *Smith*, *supra*, 323 U.S. at 117.
[53] 314 U.S. 1, 8 (1941).
[54] 306 U.S. 466, 487 (1939).
[55] 302 U.S. 134, 160 (1937).
[56] *Rockford*, *supra*, footnote 11, 482 U.S. at 191.
[57] *Ibid.*; see also *United States v. California*, ___ U.S. ___, 113 S.Ct. 1784, 123 L.Ed.2d 528, 537-38 (1993).

Davis support the petitioner, Nebraska, in this case. The validity of a state tax was affirmed because the liability of the federal government to pay its contractor was not an obligation of the United States, for purposes of §3124. In interpreting the predecessor of §3124, the Court concluded that "[t]ax exemptions being the exception rather than the rule, much clearer language evidencing an intent to immunize open account claims under [§3124] is necessary . . . ."[58]

The validity of this approach to statutory interpretation regarding a federal exemption from state taxation in general and §3124 in particular was reaffirmed by the Court in *Rockford Life Ins. Co.*, *supra*. In addressing the question of whether §3124 prohibits state taxation of obligations guaranteed by the Government National Mortgage Association, commonly known as "Ginnie Maes," this Court, quoting from *Smith v. Davis*, cautioned once again:[59]

> A court must proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly established. We do well to remember the concluding words in *Smith*, which although spoken in reference to the statute, are relevant to our role in applying the constitutional doctrine as well:
>
> > All of these related statutes are a clear indication of an intent to immunize from state taxation only the interest-bearing obligations of the United States which are needed to secure credit to carry on the necessary functions of government. That

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[58] *Smith v. Davis*, supra, 323 U.S. at 117.
[59] *Rockford Life Ins. Co.*, *supra*, 482 U.S. at 191.

> intent, which is largely codified in [§3124], should not be expanded or modified in any degree by the judiciary. 323 U.S. at 119.

Since §3124 must be construed narrowly and it does not explicitly include distributions from mutual funds attributable to income from repurchase agreements involving federal obligations, §3124 does not prohibit state taxation of this income.

CONCLUSION

Federal law, i.e., 31 U.S.C. §3124(a), and the constitutional doctrine of intergovernmental tax immunity do not prohibit State taxation of a shareholder of a mutual fund on a distribution from the fund traceable to income from a repurchase agreement involving an obligation of the United States.

The decision of the Supreme Court of Nebraska should be reversed.

Dated: April 29, 1994

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IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE,
Petitioner,

v.

JOHN LOEWENSTEIN,
Respondent.

On Writ of Certiorari to the Supreme Court of Nebraska

MOTION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE AND BRIEF OF THE DREYFUS CORPORATION AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

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MOTION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE

Pursuant to Rule 37.4 of the Rules of this Court, The Dreyfus Corporation ("Dreyfus") respectfully moves this Court for leave to file the attached brief as *amicus curiae* in this case. Counsel for the petitioner has consented to the filing of this brief, but counsel for the respondent has declined to consent. Copies of the respective responses to Dreyfus' request for consent have been filed with the Clerk of the Court.

The Dreyfus Corporation ("Dreyfus") is one of the largest mutual fund organizations in the United States, currently managing or administering more than $70 bil-

lion in assets for over 1.9 million mutual fund accounts nationwide. In providing investment management services to various mutual funds and closed-end investment companies (collectively known as "funds"), Dreyfus considers repurchase agreements and reverse repurchase agreements (collectively known as "repos") to be safe temporary investment vehicles for funds structured to pay dividends not exempt from federal income tax (herein referred to as "taxable funds"). To further ensure the safety of such taxable fund assets, the securities underlying repos consist entirely of direct obligations of the United States Treasury or other obligations specifically exempt from taxation by any state or political subdivision (collectively referred to as "federal obligations").*

Dreyfus is strongly interested in this Court's interpretation of the prohibition against direct and indirect taxation of federal obligations accorded by 31 U.S.C. Section 3124(a) and its related predecessor statutes. In this regard, Dreyfus believes that the federal prohibition against indirect state taxation accorded to shareholders of taxable funds under 31 U.S.C. Section 3124(a) should extend not only to fund dividends derived from interest on federal obligations, but also to income derived from repos to the extent such income is derived from interest on federal obligations. Because this decision could have significant ramifications on Dreyfus' investment policies as well as its taxable fund shareholders, Dreyfus has a strong interest in the outcome of this case.

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* *See, e.g.*, 12 U.S.C. Section 1433 (securities issued by the Federal Home Loan Banks); 12 U.S.C. Section 1441a(g) (obligations issued by the Resolution Trust Corporation); 12 U.S.C. Section 1725(e) (obligations issued by the Federal Savings and Loan Insurance Corporation); 12 U.S.C. Section 1825 (obligations issued by the Federal Deposit Insurance Corporation); 12 U.S.C. Section 2023 (obligations issued by Federal Farm Credit Banks); 12 U.S.C. Section 2290 (obligations issued by the Federal Financing Bank); 20 U.S.C. Section 1087-2(1) (obligations issued by Student Loan Marketing Association); and 31 U.S.C. Section 3124(a) (obligations of the United States Treasury, including, but not limited to, United States Treasury bonds, bills and notes).

Respectfully submitted,

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JUNE 1994

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IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

No. 93-823

STATE OF NEBRASKA, DEPARTMENT OF REVENUE,
Petitioner,
v.
JOHN LOEWENSTEIN,
Respondent.

On Writ of Certiorari to the Supreme Court of Nebraska

BRIEF FOR THE DREYFUS CORPORATION AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

INTEREST OF THE AMICUS CURIAE

The interest of the amicus curiae is set forth in the motion accompanying this brief.

SUMMARY OF ARGUMENT

Federal law contains a broad prohibition against direct and indirect state taxation imposed on federal obligations. It is well settled that this immunity flows through a mutual fund to its shareholders. Dividends paid to mutual fund shareholders that are derived from the mutual fund's ownership of federal obligations are immune from state taxation.

The same conclusion should apply when such dividends are derived from repurchase agreements or reverse repurchase agreements (collectively known as "repos") involv-

ing federal obligations. In that setting state taxation of the income in the hands of the shareholders will affect the investment attractiveness of federal securities, thereby increasing the federal government's cost of borrowing. Although repos have been treated in different contexts either as purchases and sales or as secured loans, the dominant view is that they are purchases and sales in which a repo investor (in this case, the mutual fund) actually earns interest on the federal obligation. Moreover, even in settings where the transactions are treated as secured loans, the law recognizes the existence of the underlying federal obligation and treats the transaction accordingly. Thus, it is appropriate to extend the immunity of 31 U.S.C. Section 3124 to income earned from repo transactions involving federal obligations.

ARGUMENT

STATE TAXATION OF DIVIDENDS EARNED BY MUTUAL FUND SHAREHOLDERS DERIVED FROM FUND INVESTMENTS IN REVERSE REPURCHASE AGREEMENTS INVOLVING FEDERAL OBLIGATIONS WOULD VIOLATE 31 U.S.C. SECTION 3124(a)

A. 31 U.S.C. Section 3124(a) broadly prohibits both direct and indirect state taxation of interest on federal obligations.

The prohibition against state and local taxation of federal obligations and the interest thereon is derived from the Supremacy and Borrowing Clauses of the United States Constitution, Article VI, Clause 2, and Article I, Section 8, respectively. The immunity of the federal government from state taxation was first articulated in *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1816). This Court has explained the constitutional principles underlying the immunity as follows:

> It is elementary that the bonds or other securities of the United States may not be taxed by state authority. That immunity always has been deemed an attribute of national supremacy and essential to its maintenance. The power of Congress to borrow money on the Credit of the United States would be burdened and might be destroyed by state taxation of the means employed for that purpose. As the tax-exempt feature tends to increase and is reflected in the market prices of such securities, a state tax burden thereon would adversely affect the terms upon which money may be borrowed to execute the purposes of the general government. . . . Neither ingenuity in calculation nor form of words in state enactments can deprive the owner of the tax exemption established for the benefit of the United States.

Missouri ex rel. Missouri Ins. Co. v. Gehner, 281 U.S. 313, 320-321 (1930).

In 1862, Congress embodied this immunity in a statute, which provided that: "(a)ll stocks, bonds, and other securities of the United States held by individuals, corporations, or associations, within the United States, shall be exempt from taxation by or under State authority."[1] Congress revised the federal statute in 1876, enacting Rev. Stat. Section 3701, 31 U.S.C. Section 742, which changed the language of the 1862 immunity provision to read simply "(a)ll stocks, bonds, Treasury notes and other obligations of the United States, shall be exempted from taxation by or under State or municipal or local authority." Although the statute prevented imposition of tax on federal obligations held directly, the statute was construed to allow state taxation of a stockholder's interests in a corporation even if the corporation's assets consisted, all or in part, of federal obligations.[2] The theory was that stock ownership represents a separate property interest from the underlying assets of a corporation.[3]

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[1] Act of Feb. 25, 1862, ch. 33, Section 2, 12 Stat. 346.

[2] *See Des Moines National Bank v. Fairweather*, 263 U.S. 103 (1923); *Cleveland Trust Co. v. Lander*, 184 U.S. 111 (1902); and *Van Allen v. Assessors*, 70 U.S. (3 Wall.) 573 (1866).

[3] *See Society for Savings v. Bowers*, 349 U.S. 143, 147-148 (1955).

In 1959, Congress modified 31 U.S.C. Section 742 by adding the following sentence to the statute:

> This exemption extends to every form of taxation that would require that either the obligations or other interest thereon, or both, be considered, *directly or indirectly, in the computation of the tax*, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate and inheritance taxes.

Pub. L. No. 86-346, Section 105(a), 73 Stat. 622 (1959) (emphasis added). In its first decision construing the amended statute, this Court characterized the new exemption created by the amendment as "sweeping" and, under its plain language, constituting a prohibition of state taxation, regardless of its form, if federal obligations must be considered, either directly or indirectly, in computing the tax. *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 862 (1983).

In *American Bank*, this Court invalidated a Texas property tax imposed on bank shareholders because the tax failed to provide a deduction for the value of federal obligations held by the bank in the calculation of the value of the bank stock. This Court explained how the amendment broadened the scope of the statutory immunity:

> the amendment abolished the formalistic inquiry whether the tax is on a distinct interest, and replaced it with the inquiry whether "computation of tax" requires consideration of federal obligations.
>
> . . .
>
> Congress understood the amendment's effect; both the Senate and the House Reports explained that the amendment "makes it clear that both the principal and interest on U.S. obligations are exempt from *all State taxes* except nondiscriminatory franchise, etc., taxes."

Id. at 867 (emphasis and quotation marks in original; citations omitted).

In 1982, the prohibition imposed by 31 U.S.C. Section 742 was transferred to 31 U.S.C. Section 3124(a), and the language was simplified. The words "directly and indirectly" were "omitted as surplus." *See* H.R. Rep. No. 651, 97th Cong., 2d Sess., *reprinted in* 1982 U.S.C.C.A.N. 1895, 1988-89. The House Report emphasized that "(t)he purpose of the bill is to restate in comprehensive form, without substantive change, certain general and permanent laws related to money and finance and to enact those laws as title 31, United States Code." *Id.* at 1895. In addressing a perceived fear that changes in language would be deemed changes in the substantive law, the House Report notes:

> (t)his fear might have some weight if this were the usual kind of amendatory legislation where it can be inferred that a change of language is intended to change substance. In a codification law, however, the courts uphold the contrary presumption: the law is intended to remain substantively unchanged.

Id. at 1897 (citations omitted). This Court has recognized that the 1982 legislative reformulation of the federal statute was made without substantive change. *See First National Bank of Atlanta v. Bartow County Bd. of Tax Assessors*, 470 U.S. 583, 585 n.1 (1985).

In summary, the history behind the amendments leading up to the current language in 31 U.S.C. Section 3124(a) evidences Congress' intent to prevent states from using any scheme of taxation, other than those expressly allowed, that would directly or indirectly include the value of or income from federal obligations in the measure of a state tax. In addition, this Court has acknowledged the strong policy basis for this immunity—namely, that state taxation of federal obligations, directly or indirectly, impacts the market value and investment attractiveness of such obligations. *See Smith v. Davis*, 323 U.S. 111, 117

(1944); and *Macallen Co. v. Massachusetts*, 279 U.S. 620 (1929).

B. The prohibitions of 31 U.S.C. Section 3124(a) are fully applicable to dividends paid to mutual fund shareholders derived from interest on federal obligations.

The respondent in this case earned dividend income attributable to a fund's investment in certain repurchase agreements and reverse repurchase agreements (collectively referred to as "repos"). The underlying assets of the repos were federal obligations. In *Burks v. Lasker*, 441 U.S. 471 (1979), in the context of a derivative action by a mutual fund shareholder, this Court viewed a mutual fund to be a "pool of assets, consisting primarily of portfolio securities, *and belonging to the individual holding shares in the fund*." *Id.* at 480 (emphasis added). *See also Tannenbaum v. Zeller*, 552 F.2d 402, 405 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977). In addition, it is well settled that a shareholder of a mutual fund (also known as open-end investment company) or closed-end investment company (collectively referred to as a "fund"), qualifying as a "regulated investment company" under Subchapter M of the Internal Revenue Code of 1986 (26 U.S.C.), as amended (the "Code"), is effectively taxed as if he or she earned income from holding the assets of the fund directly.[4] In

[4] A fund must effectively distribute, on a current basis, all of its taxable income by the end of each year to avoid the imposition of entity-level taxation. Sections 852 and 4982(a) of the Code. *Cf.* Sections 702(a) and 704(a); and *United States v. Basye*, 410 U.S. 441 (1973), where this Court stated that "it is axiomatic that each partner must pay taxes on his distributive share of . . . [a] . . . partnership's taxable income, without regard to whether that amount is actually distributed to him." Absent unreasonably accumulating earnings, as defined under Section 532, most other corporate entities do not have a similar current distribution requirement. *But see*, e.g., Section 857(a)(1), as applied to real estate investment trusts, and Section 1366(a), as applied to S corporations.

this respect, fund dividends differ from other corporate distributions, which are generally taxed as ordinary income in accordance with Sections 301(c)(1) and 316(a) of the Code, regardless of the source of such distributions (i.e., ordinary income, federally tax-exempt interest, or capital gains).[5]

This difference is reflected in a recognized tenet of state taxation—namely that, for purposes of 31 U.S.C. Section 3124(a), the character of certain fund income (in particular, federal obligation interest) passes through to fund shareholders. In this regard, the direct ownership of a federal obligation is not a prerequisite for exempting the income therefrom from state and local taxation. Of the 44 jurisdictions (43 states and the District of Columbia—collectively referred to as "states") that impose some form of personal income tax, every state either statutorily, administratively, or by judicial decision recognizes that federal law prohibits the indirect taxation of income on federal obligations earned through fund distributions.[6] The rationale for this determination

[5] However, if a corporation satisfies the requisite qualifications under Subchapter M of the Code, distributions to shareholders, in certain instances, will retain the same character as the respective income or gains earned at corporate-level. *See*, e.g., Section 852(b)(3) (retaining the character of long-term capital gains), Section 852(b)(5) (retaining the character of income exempt from federal tax under Section 103(a)), and Section 853(a) (retaining the character of foreign source income under Section 861).

[6] *See* Ala. Admin. Code r. 810-2-14.02(4)(b)(2); Ariz. Income Tax Ruling No. 84-10-5; Ark. Dept. Fin. & Admin. Rev. Policy Stmt. 1988-5; Cal. Rev. & Tax Code Section 17145; Col. F.Y.I. Income 20 (Jul. 1992); 1991 Conn. Gen. Stat. Section 12-718; Del. Code Ann. tit. 30, Section 1106(b)(1)(ii); D.C. Code Ann. Section 47-1803.3(b); CCH Georgia State Tax Reporter, Par. 15-450 (1994); Haw. Rev. Stat. Section 235-2.3 (adopting Section 851 and 852 of the Code for state tax purposes); Response to Inquiry No. 1 from CCH, Idaho State Dept. of Revenue and Taxation (Oct. 16, 1989), as quoted from CCH Idaho State Tax Reporter, Par. 10-702.23 (1994); Ill. Inc. Tax Info. Bull. Public. 101, and *Andras v. Illinois Department of Revenue*, 154 Ill. App. 3d

is twofold: (1) 31 U.S.C. Section 3124(a), as amended and interpreted by this Court's holding in *American Bank*, prohibits the direct and indirect taxation of income from federal obligations, *and* (2) the unique tax attributes of funds, which provide fund shareholders with tax treatment comparable to that received by direct investors, requires states to respect the tax-free character of fund

36, 506 N.E.2d 439 (1987), *cert. denied*, 485 U.S. 960 (1988); Ind. Dept. Rev. Info. Bull. No. 79, and *Estate of Kraft v. Indiana Department of State Revenue*, No. C85-789 (Cir.Ct. of Hamilton Co., Ind. (Dec. 2, 1986)); Order of the Director [Iowa] in *In re Everett*, Docket No. 84-215-2C-RC, and *Everett v. Iowa*, 470 N.W.2d 13 (Iowa 1991); K.S.A. 79-32,117(c)(i); 8 Ky. Tax Alerts 10 and 11; La. Rev. Stat. Ann. Section 47:293(6), and instructions to Louisiana Form IT-540 (Resident State Income Tax Return); Md. Admin. Release Nos. 5 and 11, and *Comptroller v. First Union Bank*, 578 A.2d 192 (1990); 36 M.S.A. Section 5121(2)(A); Mass. Gen. L. ch. 62, Section 2(a)(2)(A); Mich. Dept. Treas. Rev. Admin. Bull. 1986-3; Minn. R. 8002.0300 subpart 1(A)(2), and *Yurista v. Commissioner*, 460 N.W.2d 24 (Minn. 1990); Miss. Reg. 204; Mo. Code Regs. tit. 12, Section 10-2.155(2); Response to Questionnaire from CCH, Montana Department of Revenue, Income Tax Division (Oct., 1989), as quoted from CCH Montana State Tax Reporter, Par. 15-433.47 (1994); Neb. Rev. Stat. Section 77-2716(1)(b); N.H. Info. Release TIR 88-001; N.J.S.A. Section 54A:6-14.1; N.M. Income Tax Reg. Section 2.10; N.Y. Tax Law, Article 22, Section 612(c)(1); N.C. Dept. Rev. Notice (Oct. 4, 1990); N.D. Cert. Code Section 57-38-01.2(1)(c)(6); Ohio State Tax Review, Dept. of Tax., No. 18; Okla. Inc. Tax Rules Section 710:50-15-56(b); Or. Rev. Stat. Section 316.683; 72 Pa. Cons. Stat. Section 7301(f)(II); S.C. Rev. Rul. No. 91-15; Tenn. Code Ann. Section 67-2-104(f); Utah Code Ann. Section 59-10-114(2)(a), and Utah State Tax Comm'n Tax Bull. 15-19; Vt. Formal Ruling 91-7, and *In re Thomas C. Sawyer Estate*, 546 A.2d 784 (Vt. 1987); Va. Code Ann. Sections 630-2-322, 3(e)(1); W. Va. Emer. Leg. Pers. Inc. Tax Regs., 110 W.Va. Code Regs. 21, Section 12.3.2 (1988), and *Capital Preservation Fund, Inc. v. Department of Revenue*, 145 Wis. 2d 841, 429 N.W.2d 551 (Wis. Ct. App. 1988). *Cf.*, R.I.G.L. Section 44-30-12(c). Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not impose an individual income tax.

dividends derived from federal obligation interest.[7] For the reasons set forth below, this immunity for mutual fund shareholders from state taxation of federal obligations also should be extended to fund investments in repos, where the underlying assets are federal obligations.

C. Income earned through repurchase agreements and reverse repurchase agreements entered into by mutual funds is also exempt from state taxation if the securities underlying such agreements are federal obligations.

This Court has observed that repos involving federal obligations are crucial to the monetary policy of United States banking operations. *See Federal Open Market Committee v. Merrill*, 443 U.S. 340, 343 (1979). Taxable funds are active participants in the repo markets.[8] Funds operating as open-end investment companies generally use repos to maintain their liquidity to meet re-

[7] Despite the broad prohibition against state taxation of federal obligations, certain states still limit the ability of a fund to pass the character of federal obligation interest through as dividends unless the fund invests a specified minimum percentage (known as a "threshold") of its assets in federal obligations. *See* Cal. Rev. & Tax Code Section 17145(a) (requires at least 50 percent of fund assets at the close of every fiscal quarter in federal obligations); 1991 Conn. Public Acts 3, Section 52(a)(20) (requires at least 50 percent of fund assets at the close of every fiscal quarter in federal obligations); N.J.S.A. Section 54A:6-14.1 (effectively requires at least 80 percent of fund assets to be at all times in certain qualifying assets, including, but not limited to, federal obligations); and N.Y. Tax Law, Article 22, Section 612(c)(1) (requires at least 50 percent of fund assets at the close of every fiscal quarter in federal obligations). Although this case does not involve the constitutionality of the California, Connecticut, New Jersey, and New York statutes, such thresholds would violate 31 U.S.C. Section 3124(a).

[8] For a general analysis of repos and the repo markets, *see Stigum, The Money Market*, 575-630 (1990); *In re Bevill, Bresler & Schulman Asset Management Corp.*, 67 B.R. 557, 566-570, and 584-597 (D.N.J. 1986); and *Bevill, Bresler & Schulman Asset Management Corp. v. Spencer Savings & Loan Ass'n*, 878 F.2d 742 (3d Cir. 1989).

demption requirements on a timely basis. *See* Section 5(a) of the Investment Company Act of 1940, 15 U.S.C. Section 80a-5(a). Since shareholders of open-end investment companies have the right to redeem their shares on short notice, these funds often find it useful to structure a portion of their investments in federal obligations as repos.

As its name indicates, in a "repurchase agreement" involving federal obligations, a bank or other financial institution agrees to buy a federal obligation and a fund agrees to sell that obligation to the bank or other financial institution at a specified price, subject to an agreement by the fund to repurchase and by the bank or other financial institution to resell that federal obligation or similar federal obligation at a specified date (typically the next business day) for an agreed repurchase price. A "reverse repurchase agreement" usually involves the purchase of federal obligations by a fund from a bank or other financial institution pursuant to an agreement whereby the bank or other financial institution will repurchase that federal obligation or similar federal obligation from the fund at a specified date and price. With these considerations in mind, repos provide funds a convenient method to invest in federal obligations in a relatively short-term risk-free manner.

This case involves the treatment of income generated by funds engaging in reverse repurchase agreements. Specifically, the issue raised is whether such repos, whose underlying assets are federal obligations, should be accorded the protection of 31 U.S.C. Section 3124(a), thereby precluding states from taxing fund income paid as dividends to shareholders. As explained in Part B, this issue is the same as if the federal obligations were held directly by the respondent, in his individual capacity, pursuant to repo transactions.

1. *Reverse repurchase agreements are best viewed as purchase and sale agreements under which the mutual fund directly earns interest on the federal obligations.*

Upon initial examination, repos appear to possess equally balanced characteristics that enable them to be viewed as either secured loans or transactions involving the purchase and sale of their underlying securities.[9] This is best illustrated by diametric characterizations arising under various statutes, administrative pronouncements, and cases. For example, under Section 3(a)(14) of the Securities Exchange Act of 1934, 15 U.S.C. Section 78c(a)(14), the term "sale" includes ". . . any contract to sell or otherwise dispose of." Courts have still characterized repos as secured loans, while characterizing a pledge of repo securities as a sale covered by Section 10(b), 15 U.S.C. Section 78j(b), and Rule 10b-5, 17 C.F.R. Section 229.10b-5, thereunder. *See SEC v. Miller*, 495 F. Supp. 465 (S.D.N.Y. 1980). The better view, however, especially in the context of the overriding interest of preserving the exemption of federal obligations from state taxation, is to treat repos as purchases and sales of the underlying federal obligations. Under this view, the interest on the federal obligations is earned by the fund during the period before it resells the obligations, and the fund's shareholders are entitled to immunity from state taxation of that income.

For example, Section 2(3) of the Securities Act of 1933, 15 U.S.C. Section 77b(3) defines the term "sale" to include "any disposition of a security or interest in a security. . . ." Applying this definition in a transaction akin to a repo, this Court held that a pledge of stock was a sale for purposes of Section 17(a) of the Securities Act of 1933, 15 U.S.C. Section 77q(a). *Rubin v. United States*, 449 U.S. 424 (1981).

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[9] *In re Bevill, Bresler & Schulman Asset Management Corp., supra*, 67 B.R. at 597.

Another example involves the perfection of security interests in federal book-entry obligations under the Uniform Commercial Code ("UCC") as well as applicable federal regulations. It is well recognized that these transactions are treated as purchases and sales of the respective federal obligations.[10] In *In re Legel, Braswell Government Securities Corp.*, 648 F.2d 321 (5th Cir. 1981), a clearing bank involved in a repo transaction delivered securities registered in the name of the seller, indorsed in blank, and stamped "REPO SECURITIES—DO NOT TRANSFER." The court held that the clearing bank was a *bona fide* purchaser of the securities and not considered to have notice of an adverse claim of the seller.[11]

Accordingly, all transfers and pledges of federal obligations to a Federal Reserve Bank or member bank are effected and perfected by a Federal Reserve Bank making an appropriate entry on its records of the securities transferred or pledged. The making of such an entry for the account of a repo participant in the book-entry system has the effect of a "delivery" to the participant as though the federal obligations were in bearer-definitive (i.e., cer-

[10] Ordinarily, purchases and sales of repo securities must comply with the applicable provisions of Article 8 of the UCC. However, most federal obligations involved in repo transactions are now issued in book-entry form. Regulations have been issued by the Department of the Treasury relating to the transfer and perfection of security interests in federal book-entry obligations. *See*, e.g., 31 C.F.R. Section 306.115 *et seq.*; and 31 C.F.R. Section 350.0 *et seq.* Federal regulations preempt the UCC to the extent the UCC provisions are inconsistent with the regulations. *See* UCC Section 9-104(a) and UCC Section 8-321(3). Still, the UCC provisions regarding transfers of title to and security interests in securities are incorporated by reference into the federal book-entry obligation regulations. *See* 31 C.F.R. Section 306.118(b).

[11] In this regard, the UCC provides that a perfected security interest will not prevail over the claims of a *bona fide* purchaser. The UCC defines the term "*bona fide* purchaser" as a purchaser for value, in good faith, and without notice of an adverse claim. UCC Sections 8-302 and 9-309.

tificated) form.[12] Such an entry also makes the pledgee a holder and effects a perfected security interest in favor of the pledgee.[13] In this regard, courts have recognized that the authority governing transactions in federal book-entry securities, where not addressed in 31 C.F.R. Section 306.115, *et seq.* or 31 C.F.R. Section 350.0, *et seq.*, is found in Article 8 of the UCC, involving purchases and sales of securities, not in Article 9 of the UCC, involving secured transactions.[14] Therefore, the principal federal authority governing repo transactions in federal book-entry securities (of the type involved in this case) treats such transactions as purchases and sales of the underlying federal securities.

Recent amendments to the Bankruptcy Code also accord repos "purchase and sale" status. Before the 1984 enactment of Section 559 of the Bankruptcy Code, 11 U.S.C. Section 559, repos were considered secured claims in their underlying assets.[15] Section 559 provides that the

[12] *See, e.g., Wichita Federal Savings & Loan Ass'n v. Comark*, 610 F. Supp. 406 (S.D.N.Y. 1985); *Louisiana State School Lunch Employees Retirement System v. Legel, Braswell Government Securities Corp.*, 699 F.2d 512 (11th Cir. 1983); and *Matthysse v. Securities Processing Services, Inc.*, 444 F. Supp. 1009 (S.D.N.Y. 1979) (constructive possession by a purchaser's broker or purchaser's broker clearing agent constituted constructive possession under UCC Section 8-313(1)).

[13] *See* 31 C.F.R. Sections 306.118(a) and 350.4.

[14] *See In re Lion Capital Group*, 49 B.R. 163, 187 (S.D.N.Y. 1985) (Article 8 of the 1977 version of the UCC applies to federal book-entry securities); *Cosmopolitan Credit and Investment Corp. v. Blyth Eastman Dillon & Co.*, 507 F. Supp. 954 (S.D. Fla. 1981) (Article 9 of the 1972 version of the UCC was not applicable to a repo); and *In re Financial Corp. v. Occidental Petroleum Corp.*, 634 F.2d 404 (8th Cir. 1980) (Article 9 of the 1972 version of the UCC was not applicable to a repo where the court determined that it was not the intention of the parties to create a security interest). *Accord Gilmore v. State Board of Administration*, 382 So. 2d 861 (Fla. App. 1980).

[15] *See In re Lombard-Wall Inc.*, No. 82B 11556, Bankr. S.D.N.Y. (bench decision, Sept. 16, 1982), where repos were considered

exercise of a "contractual right" of a "repo participant" to liquidate a repo will not be stayed, avoided or otherwise limited by any other provision of the Bankruptcy Code. Accordingly, if a counterparty to a repo with a fund, where the underlying securities of the repo are federal obligations, were to file a petition for bankruptcy, the fund would be entitled to liquidate the underlying securities immediately. Therefore, the principal features of Section 559 effectively treat repos as purchases and sales of their underlying securities.[16] *See*, e.g., *In re Bevill, Bresler & Schulman Asset Management Corp.*, *supra*, 67 B.R. at 598, where the court concluded that, for purposes of the Bankruptcy Code, nonpossessory repos still should be treated as purchases and sales of the underlying securities.

In summary, the analysis presented above clearly supports the growing trend of federal statutory and regulatory authorities to treat repos as purchases and sales of the underlying securities. Unlike collateralized loans, the holder of the repo's underlying securities can sell such securities at will, subject only to the legal obligation to redeliver the identical or similar securities at a designated date. Applying this characterization of repos to the fund repo transactions at issue in this case, the fund in which the respondent invested is deemed to have held the underlying federal obligations during the terms of the repo transactions. Therefore, state taxation of interest income attributable to these federal obligations would constitute

secured claims for purposes of applying Section 362(a) of the Bankruptcy Code, 11 U.S.C. Section 362(a). Section 559 was intended to supplant the *Lombard-Wall* decision. *Cf.* Section 362(b)(7), 11 U.S.C. Section 362(b)(7).

[16] There is, however, one attribute of 11 U.S.C. Section 559 that appears to treat repos as secured loans. Section 559 also provides that excess of the proceeds received on the liquidation of securities subject to the repo over the sum of the stated purchase price, any interest thereon, and expenses of the liquidation must be remitted to the bankrupt debtors' estate.

indirect state taxation of federal obligations, and would violate 31 U.S.C. Section 3124(a).

2. ***Even if repurchase agreements and reverse repurchase agreements involving federal obligations are viewed as secured loans, income received by mutual fund shareholders should still be immune from state taxation.***

It is recognized that, under certain circumstances, repos may be treated as secured loans. For example, the Staff of the SEC will not commence enforcement action under Section 12(d)(3) of the Investment Company Act of 1940, 15 U.S.C. Section 80a-12(d)(3), against funds entering into reverse repurchase agreements with broker dealers, provided that the repos are "fully collateralized" during their entire term.[17] In this regard, the SEC concluded that reverse repurchase agreements "fall within the functional meaning of the term 'evidences of indebtedness' for purposes of . . . [the Investment Company Act of 1940]."[18]

Despite its treatment of repos as secured loans under the Investment Company Act of 1940, the SEC still believes that the character and identity of their underlying assets must be considered for certain regulatory purposes. For example, the SEC requires money market funds to treat a repo as an acquisition of the underlying securities where the repo is "collateralized fully."[19] Applying this standard to the repos involved in this case, their under-

[17] *See* Release No. IC-10666, 44 Fed. Reg. 25128 (Apr. 18, 1979). To be "fully collateralized," the SEC requires the value of transferred securities to be at least equal to the value of the "loan" plus accrued interest under the repo. *Id. See also* Release No. IC-17589, 55 Fed. Reg. 30239 (Jul. 25, 1990); and Release No. IC-11958, 46 Fed. Reg. 48637 (Oct. 2, 1981).

[18] Release No. IC-10666, *supra*, at 25129.

[19] *See* Rule 2a-7(c)(4)(i) under the Investment Company Act of 1940, 17 C.F.R. Section 270.2a-7(c)(4)(i); Release No. IC-18005, 56 Fed. Reg. 8113, 8127 (Feb. 27, 1991). However, the SEC re-

lying collateral was federal obligations (specifically United States Treasury Securities). Pet. App. A3. Since Section 2(a)(16) of the Investment Company Act of 1940, 15 U.S.C. Section 80a-2(a)(16), defines the term "government securities" to include ". . . any security issued or guaranteed as to principal and interest by the United States . . . ," repos collateralized by obligations of the United States Treasury should qualify as government securities under the Investment Company Act of 1940. Without regard to whether they are viewed as purchases and sales of the underlying securities or as secured loans, certain funds must look through to the underlying assets of repos in determining their treatment for federal income tax asset diversification purposes under Section 851(b)(4) of the Code, as well as for money market fund diversification purposes of Rule 2a-7 under the Investment Company Act of 1940.[20]

Given the Court's treatment of funds as pass-through entities, the same approach should govern here. *See Burks v. Lasker, supra*, 441 U.S. at 480. As such, fund repo investments should be treated as investments in federal obligations entitled to exemption from state taxation accorded under 31 U.S.C. Section 3124(a).

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cently proposed to amend Rule 2a-7 under the Investment Company Act of 1940 to allow money market funds, under certain conditions, not to treat a fully collateralized repo as an acquisition of the repo's underlying securities. *See* Release No. IC-19959, at 69, 58 Fed. Reg. 68585 (Dec. 28, 1993).

[20] The identical treatment should apply for federal income tax purposes because neither the Code nor the Treasury Regulations under Section 851 of the Code define the meaning of the term "government securities" in determining the asset diversification requirements applicable to regulated investment companies under Section 851(b)(4). Accordingly, Section 851(c)(5) directs that terms relating to Section 851(b)(4), which are not otherwise specifically defined, should have the same meaning as when used in the Investment Company Act of 1940, as amended.

3. *There is no necessary congruence between the federal and state tax treatment of income from repurchase agreements and reverse repurchase agreements.*

Some courts have held that the federal tax exemption contained in Section 103(a) of the Code does not extend to income from repos involving municipal bonds because such repos are equivalent to secured loans.[21] Even assuming that these cases were decided correctly, however, they are not inconsistent with the decision of the Nebraska Supreme Court because it relates to the immunity from *state* taxation of income on federal obligations. The standards governing federal immunity from state taxation are not the same as the standards governing state immunity from federal taxation. The federal immunity, set forth in 31 U.S.C. Section 3124(a), is essentially absolute, except as otherwise specifically provided by federal law. *See*, e.g., *American Bank & Trust Co. v. Dallas County, supra*, 463 U.S. at 864. The state immunity is not as broad. For example, in *South Carolina v. Baker*, 485 U.S. 505 (1988), this Court upheld the federal government's power to tax interest earned on municipal bonds that are not issued in registered form. Therefore, allowing federal taxation of income from repos involving municipal obligations is not incompatible with recognizing that similar income from repos involving federal obligations is immune from state taxation under 31 U.S.C. Section 3124(a).

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[21] *See* Rev. Rul. 74-27, 1974-1 C.B. 24; *First American National Bank of Nashville v. United States*, 467 F.2d 1098 (6th Cir. 1972); *Union Planters National Bank of Memphis v. United States*, 426 F.2d 115 (6th Cir.), *cert. denied*, 400 U.S. 827 (1970); and *American National Bank of Austin v. United States*, 421 F.2d 442 (5th Cir.), *cert. denied*, 400 U.S. 819 (1970) (secured loan treatment accorded to repos involving municipal obligations). *But see Citizens National Bank of Waco v. United States*, 551 F.2d 832 (Ct. Cl. 1977) where the court granted purchase and sale treatment where there was no persuasive evidence of the repo counterparty's requirement to resell the underlying securities.

CONCLUSION

The judgment of the Nebraska Supreme Court should be affirmed.

Respectfully submitted,

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JUNE 1994

BEST AVAILABLE COPY

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

No. 93-823

NEBRASKA DEPARTMENT OF REVENUE,
Petitioner,

v.

JOHN LOEWENSTEIN,
Respondent.

On Writ of Certiorari to The Supreme Court of Nebraska

BRIEF OF THE INVESTMENT COMPANY INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

The Investment Company Institute submits this brief as *amicus curiae* in support of respondent in this case. All parties have provided written consent to the filing of this brief. Letters of consent have been lodged with the Clerk.

INTEREST OF AMICUS CURIAE

The Investment Company Institute is the national association of the American investment company industry. Its membership includes open-end investment companies (commonly known as "mutual funds"), closed-end investment companies, investment advis-

ers, and principal underwriters and sponsors of unit investment trusts. The Institute's investment company members are registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, and are subject to detailed statutory and regulatory prescriptions regarding their structure, operations, and governance.

One of the Institute's main objectives is to ensure adequate legal protection of investment companies and their shareholders. In pursuit of this goal, the Institute regularly engages in legislative and private-sector initiatives aimed at increasing government and public awareness of issues affecting investment companies. The Institute has frequently appeared before this Court as *amicus curiae*, most recently in *Kamen v. Kemper Financial Services, Inc.*, No. 90-516, 111 S.Ct. 1711 (1991).

The Institute has a twofold interest in this case. Its principal concern is to ensure that the Court's disposition does not incidentally affect settled rules of mutual fund taxation that are not implicated here. It is firmly established that a mutual fund's distribution to its shareholders of income attributable to the fund's investments in U.S. government obligations is exempt from state taxation under 31 U.S.C. § 3124(a) and the Supremacy Clause. The Institute has a strong interest in ensuring that this basic precept of constitutional law is not compromised in this case.

The Institute, its members, and their shareholders likewise are concerned with the narrow question presented here—whether interest received on repurchase agreements involving federal securities is exempt from state tax. Many of the Institute's members hold re-

purchase agreements, and many mutual funds seek to offer their shareholders the opportunity to earn investment income that is wholly or largely exempt from state tax. The Court's opinion may affect mutual funds' decisions about what assets to invest in, as well as the tax treatment of dividends that mutual fund shareholders receive from their funds.

SUMMARY OF ARGUMENT

This is not a case about taxation of mutual funds or their shareholders. Nebraska concedes in this Court that mutual fund dividends are exempt from state tax to the extent they are attributable to federal interest received by the fund from investments in U.S. government obligations. Nebraska's concession in this respect is mandated by this Court's decision in *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855 (1983), which forbids any "direct or indirect" state taxation of federal obligations or the interest thereon. The exempt status of mutual fund dividends paid out of exempt federal interest is recognized by all states that impose an individual income tax, including Nebraska.

Rather, Nebraska's challenge is confined solely to whether a particular species of income—namely, interest received by investors pursuant to repurchase agreements ("repos") involving federal obligations—constitutes federal interest that is exempt from state taxation under the Supremacy Clause and 31 U.S.C. § 3124. It is irrelevant that a mutual fund happens to have been the investor that initially received the repo interest; precisely the same question would arise if respondent himself had entered into the repo transaction and received that interest directly. This case

therefore presents no occasion for the Court to address any issues peculiar to the taxation of mutual funds.

As to the taxability of repo interest, the question before the Court is not, as Nebraska contends, primarily a question about the proper *classification* of repurchase agreements as either collateralized loans (on the one hand) or sales and repurchases (on the other). This simplistic approach ignores the diversity of repo terms and conditions, as well as the fact that most repos have attributes of both loans and sales. The central question is not one of characterization but of practical economic reality: whether Nebraska's tax regime adequately preserves the broad and sweeping constitutional immunity of federal obligations from state tax when federal securities are subject to repurchase agreements.

Although the record on this issue is not fully developed, it appears that Nebraska's tax law, when coupled with the tax regimes of other states, improperly reduces the scope of the federal exemption by both disallowing deduction of repo interest to the payor and taxing that interest as income to the recipient. The decision of the Nebraska Supreme Court should thus be affirmed. However, if the Court decides to accept Nebraska's approach and concludes that the instant repo transactions were collateralized loans, we urge the Court to limit its decision to repos with terms and conditions substantially identical to those here.

ARGUMENT

I. IT IS IRRELEVANT TO THE QUESTION BEFORE THIS COURT THAT THE INTEREST RECEIVED BY RESPONDENT PASSED THROUGH A MUTUAL FUND

The question presented in this case is whether a state may tax interest income earned on a repurchase agreement involving federal securities. The initial recipient of the repo interest here was a mutual fund, which passed the interest on to its shareholders, including respondent, in the form of a dividend. But this is not a case about taxation of mutual funds or their distributions; precisely the same question would arise if respondent himself had entered into the repo transaction and received the interest directly. The case therefore presents no occasion for the Court to address any issues peculiar to the taxation of mutual funds.

1. A mutual fund is a type of investment company. Like all investment companies, mutual funds pool their shareholders' money, invest those funds in financial instruments, and distribute their investment income (less expenses) to shareholders. Mutual funds differ from other managed investment companies by virtue of their "open-end" character: there is no limit on the number of shares a mutual fund may issue, and it must redeem its shares upon a shareholder's request.[1]

Although they are usually organized as corporations, mutual funds, unlike regular corporations, function as "passthrough" entities or "conduits" for the

[1] In contrast, shares of "closed-end" funds are fixed in number and are not redeemable for cash, although they are typically traded on an established securities exchange.

passage of investment income to their shareholders. This Court has recognized the conduit nature of mutual funds for securities law purposes, describing them as "pool[s] of assets, consisting primarily of portfolio securities, and belonging to the individual investors holding shares in the fund." *Burks v. Lasker*, 441 U.S. 471, 480 (1979). The federal tax law takes the same approach, endeavoring to place mutual fund shareholders in a position comparable to that of direct investors in the portfolio held by the fund. Under the Internal Revenue Code,[2] a mutual fund that distributes 100% of its taxable income to its shareholders pays no tax at the corporate level, functioning in essence as a conduit rather than as a distinct taxable entity.[3]

The same treatment is also firmly established in state law. Of particular relevance here, all states imposing an individual income tax exempt mutual fund shareholders from taxation on dividends attributable to fund investments in U.S. government obligations.[4]

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[2] Unless otherwise noted, federal statutory references are to the Internal Revenue Code of 1986, 26 U.S.C. ("the Code" or "IRC"), as amended and currently in effect.

[3] Under IRC § 852, mutual funds pay no tax at the corporate level if they qualify as "regulated investment companies" ("RICs") by fulfilling the criteria set forth in IRC § 851(b). RICs that generally distribute at least 90% of their taxable income may deduct those distributions and so will be subject to tax only on the undistributed portion (if any) of their income.

[4] *See* Ala. Admin. Code r. 810-3-14.02(4)(b)(2); Ariz. Income Tax Ruling No. 84-10-5; Ark. Dept. Fin. & Admin. Rev. Policy Stmnt. 1988-5; Cal. Rev. & Tax. Code § 17145; Conn. Gen. Stat. § 12-718; Del. Code Ann. tit. 30, § 1106(b)(1)(ii); D.C. Code Ann. § 47-1803.3(b); Haw. Rev. Stat. § 235-2.3 (adopting IRC §§ 851 and 852 for state tax purposes); Ill. Inc. Tax Info. Bull. Public. 101 and *Andras v. Illinois Dep't of Revenue*, 506 N.E.2d 439 (Ill. App. Ct. 1987), *cert. denied*, 485 U.S. 960 (1988); Ind. Dept. Rev. Info. Bull. No. 79 and *Estate of Kraft v. Indiana Dep't of State Revenue*, Cir. Ct. of Hamilton Co., Ind. (Dec. 2, 1986); Order of the Director in *In re Everett*, Docket No. 84-215-2C-RC, and *Everett v. Iowa*, 470 N.W.2d 13 (Iowa 1991); 8 Ky. Tax Alerts 10 and 11; La. Rev. Stat. Ann. § 47:293(6) and instructions to form IT-540 (Resident Individual Income Tax Return); Md. Admin. Releases Nos. 5 and 11, and *Comptroller of the Treasury v. First United Bank & Trust Co.*, 578 A.2d 192 (Md. 1990); Mass. Gen. L. ch. 62, § 2(a)(2)(A); Mich. Dept. Treas. Rev. Admin. Bull. 1986-3; Minn. R. 8002.0300 subpart 1(A)(2) and *Yurista v. Commissioner*, 460 N.W.2d 24 (Minn. 1990); Miss. Reg. 204; Mo. Code Regs. tit. 12, § 10-2.155(2); Neb. Rev. Stat. § 77-2716(1)(b); N.H. Info. Release TIR 88-001; N.J. Stat. Ann. § 54A:6-14.1; N.M. Income Tax Reg. § 2:10; N.Y. Tax Law § 612(c)(1); N.C. Dept. Rev. Notice (Oct. 4, 1990); N.D. Cent. Code § 57-38-01.2(1)(c)(6); Ohio State Tax Review, Dep't. of Tax., No. 18; Okla. Inc. Tax Rules § 710:50-15-56(b); Or. Rev. Stat. § 316.683; Pa. Stat. Ann., tit. 72, § 7301(f)(II); S.C. Rev. Rul. No. 91-15; Tenn. Code Ann. § 67-2-104(f); Utah Code Ann. § 59-10-114(2)(a) and Utah State Tax Comm'n Tax Bull. 15-19; Vt. Formal Ruling 91-7 and *In re Thomas C. Sawyer Estate*, 546 A.2d 784 (Vt. 1987); Va. Dep't Tax'n Regs. § 630-2-322(3)(1)(e); W. Va. Emer. Leg. Pers. Inc. Tax Regs., 110 W. Va. Code Regs. 21, § 12.3.2 (1988); Instructions to Form 1, Wis. Indiv. Inc. Tax Return, and *Capital Preservation Fund, Inc. v. Department of Revenue*, No. 86 CV 1385 (Wis. Ct. App. July 21, 1988). Officials from the revenue departments of Colorado, Georgia, Idaho, Kansas, Maine, Montana, and Rhode Island have confirmed in correspondence with the Institute their position that mutual fund distributions attributable to fund investments in U.S. government obligations are exempt from state income tax. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming have no individual income tax.

This exemption is mandated by the Supremacy Clause and by 31 U.S.C. § 3124, which, as construed by the Court in *American Bank & Trust Co. v. Dallas*

County, 463 U.S. at 862-867, forbids any "direct or indirect" state taxation of federal obligations. Since mutual funds in practice are not separate taxable entities, a state's taxation of shareholders on fund distributions attributable to exempt federal interest would be an impermissible "indirect tax" on that interest. In recognition of this principle, at least 29 states revised their laws after *American Bank & Trust* to make clear that mutual fund shareholders are exempt from taxation on mutual fund dividends attributable to interest on U.S. obligations.[5]

2. The instant case involves a shareholder who received a mutual fund dividend. The tax-exempt status of mutual fund dividends attributable to interest on U.S. obligations, however, is not in dispute as the case comes to this Court. Nebraska is not contending that respondent is taxable on repo interest because that income was distributed to him in the form of a "dividend" from a mutual fund. Rather, Nebraska is contending that repo interest is not tax-exempt to begin with because it is not earned on an "obligation[] of the United States" (31 U.S.C. § 3124(a)). In the

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[5] The states in question were Arizona, Arkansas, California, Connecticut, Delaware, Illinois, Indiana, Iowa, Kentucky, Massachusetts, Maryland, Michigan, Minnesota, Mississippi, Missouri, New Hampshire, New Jersey, New Mexico, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont, West Virginia, and Wisconsin. *See, e.g.*, *Brown v. Franchise Tax Bd.*, 197 Cal. App. 3d 300 (1987); *Andras*, 506 N.E.2d 439 (Ill. 1987), *Comptroller of the Treasury*, 578 A.2d 192 (Md. 1990); *Matz v. Department of Treasury*, 401 N.W.2d 62 (Mich. 1986); *Yurista v. Commissioner*, 460 N.W.2d 24 (Minn. 1990); *Borg v. Department of Revenue*, 774 P.2d 1099 (Or. 1989); *In re Thomas C. Sawyer Estate*, 546 A.2d 784 (Vt. 1987); *Capital Preservation Fund*, 429 N.W.2d 551.

present posture of the case, it is immaterial that respondent is a shareholder in a mutual fund. Nebraska's argument in this Court would be exactly the same if respondent were a bank that received repo interest directly.

The exempt status of such mutual fund dividends, while not now a point of controversy, was at issue earlier in this litigation. Before 1991, the Nebraska Revenue Department attempted to impose a minimum threshold requirement for application of the passthrough principle, ruling in 1987 that tax-exempt federal interest did not pass through from a mutual fund to its shareholders unless 80% or more of the fund's assets were invested in federal securities. Neb. Rev. Rul. 22-87-4, Pet. App. A-32. It was to challenge this ruling that respondent originally commenced this litigation. Pet. App. A-30. The pleadings were subsequently amended to incorporate a separate challenge to Nebraska's position on the taxability of federal repo interest, the sole question now involved here. Pet. App. A-37; Neb. Rev. Rul. 22-85-1. The trial court declared both rulings unconstitutional (Pet. App. A-26, A-28), and Nebraska did not appeal that decision insofar as it invalidated the threshold requirement for application of the passthrough principle. *See* Pet. Br. 5 & n.2. The inapplicability of such a threshold requirement was confirmed in 1991 by statutory amendment. *Ibid.*; *see* 1991 Neb. Laws, LB 773, § 13, *codified at* Neb. Rev. Stat. § 77-2716 (1992).

3. Although Nebraska in this Court properly eschews any challenge to the exempt status of mutual fund dividends reflecting federal interest (Pet. Br. 12

& n.4),[6] several states as *amici curiae* belatedly endeavor to inject this issue into the case. Br. of California *et al.* at 17-22. These *amici* urge the Court to hold that "section 3124's tax exemption cannot be passed through from the mutual fund * * * to its shareholders," even where the fund's dividends indisputably consist of interest on federal obligations. *Id.* at 17-18. In effect, *amici* purport to offer an alternative basis for reversal—that respondent is taxable regardless of the tax-exempt status of repo interest generally because he received that income in the form of a mutual fund "dividend."

Amici's submission should be rejected for three distinct reasons. First, this alternative contention was not presented to the Nebraska Supreme Court and is not properly presented here. As *amici* acknowledge, Nebraska "conceded below that 31 U.S.C. § 3124(a) prohibits taxation of distributions received by respondent as shareholder of a mutual fund to the extent such distributions are traceable to interest on a federal obligation" (Br. of California *et al.* at 17). It is well established that a party in this Court may not urge, as the basis for reversal, an argument not advanced in the court whose judgment is being reviewed. *See, e.g., Kentucky v. Stincer*, 482 U.S. 730, 747 n.22 (1987); *Heckler v. Campbell*, 461 U.S. 458, 468 n.12 (1983); *McGoldrick v. Compagnie Generale Transatlantique*, 309 U.S. 430, 434 (1940); *Blair v. Oesterlein Co.*, 275 U.S. 220, 225 (1927); *Duignan v. United States*, 274 U.S. 195, 200 (1927). Much less

[6] In view of Nebraska's concession on this point, its phrasing of the question presented to include the words "received by shareholders of mutual funds" (Pet. Br. i, 12) is somewhat inaccurate.

should an *amicus* be permitted to advance such an argument when the party it supports explicitly disavows that contention.

Second, *amici*'s alternative argument would not lead to reversal even if it were properly presented here. Since 1991 Nebraska has statutorily mandated full passthrough of exempt federal interest to mutual fund shareholders. *See* page 9, *supra*. Thus, acceptance of *amici*'s submission that passthrough is not constitutionally required would make absolutely no difference to this taxpayer, who is seeking *declaratory* relief. *See* Pet. Br. 5-6 & n.2. *Amici* in effect ask this Court to render an advisory opinion on a subject that is not disputed and—in view of Nebraska's statute—could not possibly be disputed between the parties.

Third, *amici*'s alternative argument is wrong on the merits in any event. As explained previously, mutual funds act as conduits in passing investment income through to their shareholders, placing shareholders in a position comparable to that of direct investors in the fund's portfolio. Thus, state taxation of mutual fund dividends attributable to interest on federal obligations would constitute an "indirect" tax on such interest, which 31 U.S.C. § 3124(a) forbids. *See American Bank & Trust Co.*, 463 U.S. at 862-867. It was precisely in recognition of this fact that 29 states amended their laws after *American Bank & Trust* to confirm that mutual fund shareholders are exempt from state tax in these circumstances. *See* page 8, *supra*.[7]

[7] California and its *amici* assert that mutual fund distributions are simple corporate dividends and thus cannot be immunized

In sum, because Nebraska acknowledges the conduit treatment of mutual funds for tax purposes, the fact that the repo interest passed through a mutual fund is irrelevant to the Court's decision in this case. The Court's decision, of course, will have an ancillary effect on the taxability of mutual fund distributions insofar as it determines the taxability of the mutual fund income from which such distributions are made. But any such effect will be due solely to the fact that mutual funds, like other investors, may invest in repo securities, and not to any status or attributes peculiar to mutual funds *per se*.

II. REPO INTEREST OF THE TYPE RECEIVED BY RESPONDENT IS EXEMPT FROM STATE TAXATION

Following the approach of other state courts that have considered the issue, Nebraska contends that this case presents primarily a question about the proper *classification* of repurchase agreements. Nebraska urges that a repo is "really" a collateralized loan; that the recipient of repo interest is not the "true owner" of the underlying federal securities; and that repo interest therefore enjoys no immunity from state tax. *See* Pet. Br. 8-9, 23-32; Pet. App. A-12. By parity of reasoning, if a repo were "really" a sale and repurchase, the recipient of repo interest would be the "true owner" of the federal securities, and repo interest would presumably be tax exempt. Nebraska urges, in other words, that the tax result follows more or less automatically once the true nature of repurchase agreements is deciphered.

from state taxation by 31 U.S.C. § 3124. This argument, which has been rejected by numerous state courts considering the issue, *see* page 8 n.5, *supra*, ignores this Court's decision in *American Bank & Trust*, the broad scope of the § 3124 exemption, and the unique status of mutual funds as passthrough entities.

The Nebraska Supreme Court declined to follow this simplistic approach, stating: "We do not believe that direct ownership determines whether income from a repo agreement is exempt under [31 U.S.C.] 3124" (Pet. App. A-12). The Institute agrees with that statement. The approach that Nebraska urges in this case ignores the diversity of the repo market and the immense differences among transactions that are labeled "repos." Even if the focus is limited to the specific kind of repurchase agreements involved here, an inquiry into their classification yields no certain or unambiguous result in view of the securities' hybrid nature.

Most importantly, the approach urged by Nebraska asks the wrong question because it ignores the scope and significance of the federal constitutional immunity. The outcome of this case should not turn on the "true nature" of repo transactions in some abstract or recondite sense. The question, rather, is whether state tax regimes like Nebraska's properly preserve—or, as we believe, improperly restrict—the federal exemption when federal securities are subject to repurchase agreements.

A. The Diversity And Scale Of The Repo Market Make Generalizations About Repos Hazardous

Nebraska uses the term "repurchase agreement" as if its meaning coincides with the particular type of transaction before the Court in this case. In actuality, the repo market comprises a large variety of transactions that serve a range of diverse purposes and affect many aspects of our economy. Beyond their

most basic defining features, repos diverge widely in their terms and conditions. Many, if not most, differ significantly from the repos in this case. Therefore, if the Court accepts Nebraska's invitation to make the outcome turn on the proper "classification" of repurchase agreements, we urge that the Court limit its decision to repos with terms and conditions substantially identical to those here.

1. In its most basic form, a repo consists of a sale of securities by a "repo dealer" to a "repo participant" and a concurrent agreement that the repo dealer will repurchase the securities at a later date. A "reverse repo" is the identical transaction viewed from the perspective of the repo participant: the repo participant purchases securities from the repo dealer and agrees later to sell them back. In either case, the stated repurchase price is typically the original sale price plus an additional amount representing the time value of money, *i.e.*, interest.[8] The amount of interest on the repo is unrelated to the interest rate

[8] A comprehensive description of the repo market is contained in Marcia Stigum, *The Repo and Reverse Markets* (1989) [hereinafter Stigum, *Repo Markets*], and Marcia Stigum, *The Money Market* 575-630 (1990) [hereinafter Stigum, *Money Market*]. Other valuable sources include *In re Bevill, Bresler & Schulman Asset Management Corp.*, 67 B.R. 557, 566-70, 584-97 (D.N.J. 1986); Alan S. Dunning, *Repurchase and Reverse Repurchase Agreements* (PLI Commercial Law & Practice Course Handbook Series No. 290, 1982); Alan S. Dunning, *Repurchase and Reverse Repurchase Agreements Revisited 1984*, (PLI Commercial Law & Practice Course Handbook Series No. 341, 1984); Dennis E. Logue, *Handbook of Modern Finance* A3-18-A3-20 (1994); Charles M. Lucas, *Federal Funds and Repurchase Agreements*, Fed. Reserve of N.Y. Q. Rev. 33 (Summer 1977) [hereinafter Lucas, *Federal Funds*].

borne by the underlying securities. Instead, the repo interest rate is typically determined by reference to the federal interest rate paid on obligations with a term corresponding to that of the repo. *See* Stigum, *Repo Markets*, *supra*, at 6; *In re Bevill, Bresler*, 67 B.R. at 567.

Repos and reverse repos serve a variety of purposes for a variety of market participants. The Federal Reserve Board uses them to implement monetary policy through the manipulation of bank reserves, especially by offsetting the effects of day-to-day changes in currency circulation. *See* Pet. Br. 15-16; Br. of Federal Reserve Bank of N.Y. ("N.Y. Fed.") at 6-7. Repos are superior to outright purchases and sales for these purposes because of their liquidity and because they do not disrupt market flows the way large volumes of purchases and sales might do. *See* Stigum, *Money Market*, *supra*, at 95-96; *In re Bevill, Bresler*, 67 B.R. at 567. Dealers and investors use repos to finance their portfolios. *See* Pet. Br. 16; Br. of N.Y. Fed. at 4, 6. Banks especially favor them because funds acquired through repos involving federal securities are not subject to reserve requirements. 12 C.F.R. § 204.2(a)(1)(vii)(B).

Reverse repos are used by dealers and investors to obtain securities to deliver to a buyer after entering into a "short" sale. *See* Br. of N.Y. Fed. at 5; Stigum, *Money Market*, *supra*, at 595, 598-600; Lucas, *Federal Funds*, *supra*, at 44. In addition, various investors—including municipalities, mutual funds, pension funds, and banks—use reverse repos as short-term, highly liquid tools for obtaining a respectable yield on funds. For many of these institutions, reverse repos have significant advantages over outright purchases or

loans. *See* Pet. Br. 16; Br. of N.Y. Fed. at 5, 6. Mutual funds and corporations engage in reverse repos to earn interest while maintaining the liquidity necessary to redeem shares or meet payrolls. Banks favor reverse repo transactions involving federal securities because lending limits do not apply to them. 12 C.F.R. § 32.103(a).

2. Given the multiple purposes repos and reverse repos serve and the variety of participants in the repo markets, it is not surprising that repo agreements vary significantly in their terms and conditions. Beyond the basic features (discussed above) common to repos generally, these transactions come in all shapes and sizes. Any type of security can be subject to a repo, although the vast majority of repos involve U.S. Treasury obligations. Repo agreements typically require actual delivery of the securities to the repo participant, usually through the Federal Reserve book entry system; alternatively, they may authorize the repo dealer to hold the securities for the participant's account. Still other repos, known as third-party repos, involve the appointment of the repo dealer's clearing bank as custodian for the repo participant; in such cases, delivery is indicated on the books of the custodian/clearing bank. Most repos are overnight investments or have a term no longer than a few weeks. But they can have set terms as long as a year or be "open." Open repos, also known as "continuing contracts," are indeterminate in length and can be terminated by either party at any time. *See In re Bevill, Bresler*, 67 B.R. at 570; Stigum, *Money Market*, *supra*, at 588; Lucas, *Federal Funds*, *supra*, at 35.

Repos also differ in the rights they accord the dealer and the participant. Dealers of open repos usually

reserve the right to take back particular securities from the repo participant and substitute other securities of the same type and of equal worth in case the dealer needs the original securities before the repo is terminated. Some repo agreements give the repo participant the right to revalue the securities on a daily basis. Thus, if the securities' value falls below a margin built into the sale, the participant may insist that the dealer provide additional securities to make up the difference. *See* Stigum, *Repo Markets*, *supra*, at 188, 217; Stigum, *Money Market*, *supra*, at 588; Lucas, *Federal Funds*, *supra*, at 45.

Finally, the repo participant may or may not have the right to retransfer the securities it purchases from the repo dealer. Some repo agreements prohibit the participant from trading or encumbering the securities unless the dealer defaults. Such limits are the exception rather than the rule, however, as they nullify the purpose of many repos. Investors who enter into reverse repos when creating short sales, for example, must be able to retransfer the securities to purchasers. Dealers in the repo market, as opposed to institutional investors, typically enter into repos and reverse repos not to earn a return on funds, but to earn a spread by purchasing a security as a repo participant and then selling that security as a repo dealer at a slightly lower interest rate. These people would not enter into repo transactions at all if their right to retransfer the securities were restricted. As a result, most repo agreements do not regulate the participant's disposition of the security during the term of the agreement, instead requiring only that he return the security—or in some cases any security

of equivalent value—to the repo dealer on the specified date. *See In re Bevill, Bresler*, 67 B.R. at 570.

3. The repos involved in the instant case represent a particular specimen of the varied species described above. All were reverse repos entered into by mutual funds as a way of earning interest while retaining greater portfolio liquidity and incurring less market (price) risk than would be possible with a direct investment in Treasury securities. The repo dealer was typically a bank or registered broker/dealer, and the securities subject to the repo were long-term Treasury obligations. The standard repurchase agreement executed by the mutual funds (J.A. 65) gave them certain rights protecting their investment, *e.g.*, the right to information about the dealer's financial condition and the right to demand delivery of additional securities should the market decline. J.A. 69-70, 71. But the agreement expressly prohibited the mutual funds from alienating the securities in their possession; unless the dealer defaulted, the funds were barred from reselling or reregistering the securities underlying the repo. J.A. 69. This restriction is relatively uncommon outside the mutual fund arena, and it distinguishes the repos in this case from most other repos. *See* Br. of N.Y. Fed. at 4 & n.3. (noting that repos like the ones involved in this case are "atypical").

The repos at issue here, in light of their atypical terms and limited purpose, do not provide a sound basis for fashioning general rules applicable to all such transactions. Nebraska and its state *amici*, in urging the blanket taxability of all "repo interest," simply ignore the differences among repo transactions. Moreover, the record is devoid of evidence concerning other types of repos, their terms and conditions, and how

they might be affected by the Court's decision in this case. However the Court decides the merits, we urge that it confine its decision to repo transactions substantially identical to those at issue here and avoid fashioning unnecessarily broad rules that could adversely affect segments of the repo market not before the Court.[9]

B. State Tax Regimes Affecting Repo Transactions May Improperly Restrict The Constitutionally-Mandated Immunity Of Federal Obligations From State Taxation

1. Nebraska asks the Court to resolve this case by determining that a repo is in reality a collateralized loan rather than a purchase and sale. Indeed, the state court cases Nebraska cites to support its position all viewed the issue before them as requiring such a determination. Those courts reasoned that only the "true owner" of a federal obligation is entitled to claim an exemption from state tax on the interest received; and that, if a repo is actually a loan, the repo participant is not the "true owner" of the federal securities. *See, e.g., Hammond Lead Products, Inc. v. Indiana Tax Comm'rs*, 575 N.E.2d 998, 1001 (Ind. 1991); *Comptroller of the Treasury*, 578 A.2d at 192, 199-203; *Andras v. Illinois Dep't of Revenue*, 506 N.E.2d at 443-445. Under this approach, the Court's

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[9] As Nebraska recognizes (Pet. Br. 20 n.9), the Internal Revenue Service has declined to adopt blanket rules governing the taxability of all repos, instead fashioning in its rulings on municipal repo interest an approach that considers all the facts and circumstances surrounding the particular transaction in question, analyzing each repo according to its precise terms and conditions. *See* Rev. Rul. 74-27, 1974-1 C.B. 24.

task is basically concluded once the "true nature" of repos is divined.

The Institute believes that the approach Nebraska advocates is neither a useful avenue of inquiry nor the correct mode of constitutional analysis. Repo agreements vary widely. Some are structured to resemble a loan, while others have features more typical of a purchase and sale. But all repos manifest attributes of both. In short, repos are "hybrid transactions which do not fit neatly into either a secured loan or purchase and sale classification." *In re Bevill, Bresler*, 67 B.R. at 597.

The treatment of repos in various regulatory contexts confirms that they are not susceptible to obvious categorization and may be different things for different purposes. For financial accounting purposes, the treatment of repos varies with the nature of the participating entity. Generally accepted accounting principles ("GAAP") require broker/dealers and commercial banks to account for repos as financing transactions—*i.e.*, as loans—whereas state and local governments must record them as purchases and sales. *See In re Bevill, Bresler*, 67 B.R. at 591-592. Federal banking regulations governing lending limits on commercial banks treat a reverse repo as a purchase and resale. *See* 12 C.F.R. § 32.103(a) (purchase of federal securities "subject to an agreement that the seller will repurchase [them] at the end of a stated period is not a loan or extension of credit for purposes of this part") (emphasis omitted). The SEC has issued a policy statement characterizing repos as purchases and sales for most securities law purposes. SEC Exchange Act Release 34-18122, 46 Fed. Reg. 48637 (Oct. 2, 1981). However, with respect to the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, which regulates borrowings by registered investment companies, the SEC considers repos to be secured loans. Investment Company Act Rel. No. 10666, 44 Fed. Reg. 25128, 25129 (Apr. 27, 1979).

In the bankruptcy context repos are explicitly acknowledged to be hybrid instruments. Section 559 of the Bankruptcy Code (11 U.S.C.) suspends application of the automatic stay provisions to repo transactions. Thus, upon a repo dealer's bankruptcy, repo participants may liquidate the underlying securities immediately, as if the transaction entailed an outright purchase. But § 559 also requires any proceeds from the sale of the securities in excess of the agreed repurchase price to be remitted to the bankrupt repo dealer's estate, in recognition of the fact that the transaction also has attributes of a secured loan. *See also In re Bevill, Bresler*, 67 B.R. at 598 (concluding that nonpossessory repos involved in that case were purchases and sales for bankruptcy purposes).

This survey of the varied legal attributes of repos suggests the futility of trying to pigeonhole repo transactions for state tax purposes. *Cf.* Br. of N.Y. Fed. at 4 n.3 (any attempted characterization of repos is "dangerous"). Nebraska's invocation of the doctrine of "form versus substance" (Pet. Br. 9, 17-22) offers no talisman: "substance" is no less important for bankruptcy or securities law purposes than it is for tax purposes. Moreover, to ask whether repos are really secured loans or purchases and sales poses the wrong question. To approach this case as involving a mere matter of classification obscures the true issue, which is not who "owns" the federal obligation, but whether taxation of the interest received by the repo

participant impermissibly encroaches on the constitutional immunity of federal securities from state tax. *Cf.* Br. of N.Y. Fed. at 7.

2. The rule that instrumentalities of the federal government are immune from state and local taxation is grounded in the Supremacy Clause of the Constitution. *See McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819). Since 1862 this rule also has been codified by statute. *See* Act of Feb. 25, 1862, ch. 33, 12 Stat. 345 (1863); Rev. Stat. § 3701 (1878); 31 U.S.C. § 742 (1959). The statute in its current form (31 U.S.C. § 3124(a)), enacted in 1982 without substantive change from its predecessors, provides:

> Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except [a nondiscriminatory franchise tax imposed on a corporation or an estate or inheritance tax].

This provision essentially restates the constitutional rule. *See First National Bank v. Bartow Cty. Tax Assessors*, 470 U.S. 583, 593 (1985); *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983); *New Jersey Realty Title Ins. Co. v. Division of Tax Appeals*, 338 U.S. 665, 672 (1950); *Missouri ex rel. Missouri Ins. Co. v. Gehner*, 281 U.S. 313, 321-322 (1930).

The Court has repeatedly affirmed the breadth of this immunity. It has described § 3124(a) and its predecessors as embodying a "broad" and "sweeping" exemption that is "inconsistent with implied exceptions"

and extends to "every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax." *American Bank & Trust Co.*, 463 U.S. at 864 (emphasis omitted); *Memphis Bank & Trust Co.*, 459 U.S. at 395. In enacting § 3124(a), the Court has stated, "Congress intended to sweep away formal distinctions and to invalidate all taxes measured directly or indirectly by the value of federal obligations." *American Bank & Trust Co.*, 463 U.S. at 867. Nebraska correctly acknowledges the "broad" and "sweeping" nature of the federal exemption (Pet. Br. 34), disavowing its *amici*'s effort to portray the exemption as "narrow" (Br. of California *et al.* at 7).

The test for deciding if a state tax law impinges on this broad exemption is whether the law takes a federal obligation into account, or includes it in the accounting of a state tax, no matter how indirect this "taking into account" may be. *American Bank & Trust Co.*, 463 U.S. at 862-863. Any state tax that "diminish[es] in the slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit" is invalid under this rule. *Smith v. Davis*, 323 U.S. 111, 117 (1944).

3. Any case involving federal immunity from state taxation presents this Court with a twofold task. The Court must take care that the federal immunity is preserved intact and not compromised or reduced. Conversely, the Court must ensure that the federal immunity is not abused or improperly invoked where the Federal Government's ability to secure credit is not at stake. As it arises here, this task requires the

Court to decide whether the state tax treatment of repurchase agreements involving federal obligations impairs the federal exemption. If that question is answered affirmatively, the state treatment is invalid regardless of how the repo transaction is denominated.

In considering this question, the Court should evaluate how state tax laws treat *both sides* of the repurchase agreement. Both the repo participant and the repo dealer receive interest in the course of the transaction, and both parties have a potential claim that part or all of the interest they receive is exempt from state tax. If the parties in effect divide the exemption between them—such that the aggregate exemption claimed and allowed does not exceed the amount of interest actually paid by the Treasury—there has been no abuse or "double-counting" of the federal immunity from state tax. To the contrary, the exemption in this event has simply been preserved inviolate.

An assessment of how state tax regimes affect repo transactions in their entirety reveals that the treatment urged by Nebraska for the repo participant here, in conjunction with the treatment accorded the repo dealer by Nebraska and (apparently) by most other states, has the effect of improperly reducing the scope of the federal exemption. Most state corporate income taxes begin with the corporation's federal taxable income, then require various upward and downward adjustments to conform with state law. These adjustments invariably permit the corporation to reduce its federal taxable income by interest received

on federal obligations.[10] On the other hand, these adjustments commonly require that interest expense related to receipt of federal interest income, normally deducted for federal tax purposes, be "added back" to income for state tax purposes. To accomplish this result, some states (including Nebraska) have enacted provisions explicitly requiring corporations to add back interest on indebtedness "incurred or continued to purchase or carry" obligations the interest on which is wholly exempt from state tax.[11] Other states achieve the same result with broader provisions requiring the adding back of any expenses allocable to, or related to the production of, tax-exempt income.[12] State in-

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[10] Franchise taxes present an exception to the general rule that federal obligations cannot enter into the calculation of a state tax. *See* 31 U.S.C. § 3124(a)(1). Thus, state franchise tax laws—and equivalent excise or license tax laws—generally do not allow exclusion of federal interest in calculating the corporation's liability. States that have such franchise-type taxes, in lieu of or in addition to a corporate income tax, include California, Idaho, Massachusetts, Michigan, Minnesota, Montana, New Jersey, New York, Tennessee, Texas, Wisconsin, and Wyoming. Nevada and Washington do not tax corporations at all.

[11] *See* Alaska Admin. Code tit. 15, § 20.620(a); Ariz. Rev. Stat. Ann. §§ 43-1121(4), 43-1122(6); Ark. Code Ann. §§ 26-51404(b)(6), (c); Haw. Rev. Stat. § 235-7(a)(1) & (e)(1); Idaho Code § 63-3022(a)(1), (g); Mo. Rev. Stat. §§ 143.431.2, 143.121(a); Neb. Rev. Stat. § 77-2716(1)(a), (b) & (e); N.C. Gen. Stat. § 105-130.5(a)(2), (b)(1), (c)(3); Ohio Rev. Code Ann. § 5733.04(11); Okla. Stat. tit. 23, § 2358(A)(2), Okla. Admin. Code tit. 710, r. 50-17-51(E); Pa. Stat. Ann. tit. 72, § 7401(b), Pa. Rev. Dept. Corp. Tax. Bull. 111, REV-176 CT (8/91); S.C. Code Ann. § 12-7-430(b)(1), (d)(4).

[12] *See, e.g.*, Ala. Code §§ 40-18-34, 40-18-14(2)(d) & 40-18-35(a)(2), Ala. Admin. Code r. 810-3-35.01(d); Cal. Rev. & Tax. Code § 24425, Cal. Regs. tit. 18, § 24271(e)(2)(B); Del. Code Ann. tit. 30, § 1903(a)(2); D.C. Code Ann. §§ 47.1803.2(a)(2)(A),

dividual income taxes generally include similar provisions.[13]

The practical effect of these addback provisions, when coupled with the position of Nebraska (and most other states) on the taxability of the repo participant,[14] is to reduce the scope of the federal exemption. This effect may be illustrated by an example. Assume that a repo dealer holds federal securities that pay $100 of interest, and that those securities are the subject of a repo in which the dealer pays the repo participant $30 of interest. Assume further that the dealer at year-end has federal taxable income of $500, which includes the $100 of federal interest and reflects a $30 deduction for interest paid to the participant. Under state law, the dealer would typically be permitted to reduce its federal taxable income by the $100 of federal interest, but it would also be

47.1803.3(d)(6)(A); Ga. Code Ann. § 48-7-21(b)(1)(B); Kan. Stat. Ann. §§ 79-32, 79-138(c)(i) & 79-117(c)(i); Ky. Rev. Stat. Ann. § 141.010(12)(a) & (13)(d); La. Rev. Stat. Ann. §§ 47:287.71(B)(1) & 47:287.81; Minn. Stat. § 290.10; Miss. Code Ann. §§ 27-7-15(4)(d) & 27-7-17(1)(b); N.M. Stat. Ann. § 7-2A-2(I)(2); Wis. Stat. § 71.26(3)(b) & (*l*).

[13] *E.g.*, Cal. Rev. & Tax. Code §§ 17270, 17280(b)(2); Conn. Gen. Stat. § 12-701(a)(2)(A)(vii), (b)(i); D.C. Code Ann. § 47-1803.3(d)(6)(A); Ga. Code Ann. § 48-7-27(b)(2); Ky. Rev. Stat. Ann. § 141.010(11); Mass. Gen. L. ch. 62, § 2(d)(1)(B); Minn. Stat. § 290.10; Neb. Rev. Stat. § 77-2716(1)(e); N.Y. Tax Law § 612(b)(4); Pa. Dept. Rev. Regs., tit. 61, § 103.16(a); R.I. Gen. Laws § 44-30-12(c)(1); S.C. Code Ann. § 12-7-430; Va. Dep't Tax'n Regs. § 630-2-322(3)(1)(f); Wis. Stat. § 71.05(6)(b)(1).

[14] All States now appear to treat federal repo interest as taxable, either according to administrative practice or under statute or regulation. *Cf.* Br. of the Council of State Governments *et al.* at ii n.*.

required to "add back" the $30 of interest paid to the repo participant, yielding state taxable income of $430.

In this example, it seems clear that only $70 of the dealer's income—the *net* interest income he derives from the repo transaction—enjoys any exemption from state tax. If, as Nebraska contends, the repo participant is fully taxable on the $30 of interest it receives, the federal exemption has been improperly reduced. Although the federal securities underlying the repo pay $100 of interest that is indisputably exempt from state tax, the repo participant and the repo dealer together enjoy an exemption of only $70. The federal exemption, in other words, has "shrunk" by 30%, for no reason other than that the federal securities have been the subject of a repurchase agreement.

The record in this case is virtually silent as to the tax treatment that various states accord repo dealers in repurchase transactions. Although this is basically a legal inquiry, state laws on the subject are often less explicit than might be wished, and the treatment may sometimes depend on state tax authorities' actual audit practice. If the Court agrees with our submission that the tax treatment of both sides of the repo transaction is relevant in deciding the question presented here, the Court may wish to await another case in which the record is more fully developed, and dismiss the instant petition as improvidently granted. Alternatively, if the Court concludes that the practice of the other states is sufficiently clear—or that the question can be answered by reference to Nebraska's practice alone—it should affirm the decision of the Nebraska Supreme Court.[15]

[15] California and its *amici* argue alternatively that, if a repo

C. Precedents Concerning The Federal Tax Treatment Of Interest Received On Repos Involving Municipal Bonds Are Inapposite Here

On two prior occasions, federal courts have held that interest received by municipal bond repo participants is subject to federal income tax notwithstanding IRC § 103(a)(1), which exempts from tax interest on state and local bonds. The rationale of these decisions was that the repos were really collateralized loans, and that the § 103(a)(1) exemption applies only to the "owner" of the bonds. See *Union Planters National Bank of Memphis v. United States*, 426 F.2d 115 (6th Cir. 1970); *American National Bank of Austin v. United States*, 421 F.2d 442 (5th Cir. 1970). The Fifth Circuit did not address the impact of IRC § 265(a)(2), which, like the state tax provisions discussed earlier, denies a deduction for "interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt" from tax. The Sixth Circuit did discuss that provision, concluding that treatment of the repo transaction as a purchase and sale would enable the parties "to enjoy the benefit of the double tax advantage which Congress intended to prevent" (426 F.2d at 116).

This Court has never considered the appropriate treatment of municipal bond repo interest. But even

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is really a sale/repurchase, the income is not interest but taxable capital gain. Br. of California *et al.* at 13. This argument is meritless. It is absolutely clear that the difference between the sale and repurchase prices for the security underlying the repo is 100% attributable to the time value of money. For that reason, the differential constitutes interest for tax purposes, just as in the case of obligations issued at a discount. *See, e.g.*, Treas. Reg. § 1.61-7(c).

if one assumes that these two appellate decisions are correct, they do not justify parallel treatment of federal repo interest. Section 103 of the Code embodies no constitutional requirement; as a statutory exemption from federal tax, it is, like other exemptions and deductions, a matter of legislative grace. *See South Carolina v. Baker*, 485 U.S. 505, 524 (1988). Congress may thus limit and define the exemption for municipal bond interest as it sees fit. And since the exemption is intended as an incentive for taxpayers to invest in local government, it is not unreasonable to assume that Congress intended its benefits to inure only to taxpayers who actually "incur[] the risk that ownership of municipal bonds entails." *American National Bank of Austin*, 421 F.2d at 451.

The states have no such latitude to define the immunity of federal obligations from state tax. That immunity, while codified by statute, is constitutionally grounded; it is not a product of the states' largesse. The Supremacy Clause dictates the immunity of federal obligations from state taxation in order to ensure the Federal Government's ability to secure credit, a purpose vastly different from simply encouraging private individuals to invest in local government. *See Smith*, 323 U.S. at 115-119. Whereas limiting an exemption to the "actual owner" of the security might be a reasonable way of achieving the latter goal, ownership is far less relevant when the question is whether a state tax diminishes the attractiveness of the federal securities market, or whether a constitutionally mandated immunity is compromised by state laws that deny both an exemption for repo interest income and a deduction for repo interest payments.[16]

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[16] California and its *amici* suggest that any difference in the

CONCLUSION

The decision of the Nebraska Supreme Court should be affirmed. Alternatively, the Court may wish to dismiss the petition for writ of certiorari as improvidently granted.

Respectfully submitted.

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tax treatment of municipal and federal repo interest would constitute impermissible discrimination against state obligations in favor of federal obligations, in violation of the principles of intergovernmental tax immunity. Br. of California *et al.* at 23. This argument assumes that the protection this doctrine offers the federal government against state discrimination in favor of state obligations is precisely identical to the protection it offers states against federal discrimination in favor of federal obligations. *Amici* cite no cases in support of this proposition. In any event, the federal taxability of municipal repo interest is not now before, and has never been before, this Court. Any argument about impermissible "discrimination" is thus an issue for another case.